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NO. 917

IN THE

Supreme Court of the United States

October Term, 1968

W. H. COCKE, ET AL., *Petitioners*

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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v.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioners, W. H. Cocke, William Howell Cocke, Sr., Independent Executor of the Estate of Tula Stokes Cocke, deceased, William H. Cocke, Jr., and Beulah R. Cocke, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above entitled and numbered cause (No. 23,963 below) reversing the judgment of the District Court of the United States for the Southern District of Texas, Houston Division, that was in favor of petitioners.

CITATION TO OPINIONS BELOW

The opinion of the District Court (R. 143-150, Appendix A, hereto, p. 29) is reported in 263 F. Supp. 762, and its judgment in favor of petitioners is at R. 151-152. (Appendix B, hereto, p. 37). The opinion of the Court of Appeals reversing the judgment of the District Court (R. 168-218, Appendix C, hereto, p. 39) is reported in 399 F.2d 433. The judgment of the Court of Appeals reversing the judgment of the District Court (R. 220, Appendix D, hereto, p. 84) was entered July 31, 1968. The order of the Court of Appeals denying petitioners' petition for rehearing (R. 229, Appendix E, hereto, p. 86) was entered October 16, 1968.

JURISDICTION

Jurisdiction of the Court is invoked under 28 U.S.C., Sec. 1254(1).

PRELIMINARY STATEMENT

This case is of widespread importance of the first magnitude. The opinion below (Footnote 27, R. 209) shows that the Service advised the court that there were then ten additional cases pending involving carried interests transactions. Judge Ainsworth in his separate opinion stated (R. 216):

> "We are informed that there are ten pending cases in the Internal Revenue Service involving carried interest transactions, five of which affect the Cockes. The popularity of the carried interest agreement in the petroleum industry permits the inference that it is likely there are a large number of such contracts in existence which will now be affected by our decision."

QUESTIONS PRESENTED

1. Petitioner W. H. Cocke and his wife (the latter passed away while this case was in the Court of Appeals and he as executor of her estate was substituted for her) R. H. Goodrich, and Humble Oil & Refining Company owned the oil and gas mineral interests in certain lands in Louisiana and executed an operating contract dated October 12, 1955, in which Humble was designated as the Operator.

W. H. Cocke and wife, and petitioners William H. Cocke, Jr., and wife, R. H. Goodrich, H. R. Goodrich, The California Company and Humble Oil & Refining Company owned the oil and gas mineral interests in certain other lands in Louisiana and executed an operating contract dated January 1, 1956, in which Humble was designated as the Operator.

Both contracts recognized that all the parties owned working interests as distinguished from net profits interests or royalties or overriding royalties. Each contract specifically set out the fractional interest each owned in the joint area, in the oil and gas to be produced, in the physical properties to be installed, and in the expenses to be borne by each. The contracts provided that Humble as the Operator should pay the share of the expenses incurred by petitioners and could reimburse itself out of one-half of W. H. Cocke's part of the production under the first contract and out of one-quarter of the production owned by the two Cockes under the second contract.

The years involved in this case are 1958 for W. H. Cocke and wife (Complaint, R. 41) and 1957 for William H. Cocke, Jr., and wife (Complaint, R. 155). The two cases were consolidated by the District Court (R. 50).

Those two years were taken as test cases and, since the properties are still actively producing oil and gas, all tax years of petitioners subsequent to 1957 and 1958 have been kept open and a final decision in this case will control those later years.

The Internal Revenue Service held that petitioners could not include in their income the part of their production taken by Humble, could not take depletion on that part, could not take depreciation on that part of the physical properties paid for by their part of the production taken by Humble, and could not deduct as intangible drilling expenses that part of those expenses for which Humble recouped itself out of their production.

The District Court, following the decision of the Fifth Circuit Court of Appeals in *Commissioner of Internal Revenue v. J. S. Abercrombie Co.*, 162 F.2d 338, in 1947 and its later cases to the same effect in *Prater v. Commissioner*, 273 F.2d 124, (1959), and *Sowell v. Commissioner*, 302 F.2d 177, (1962), held for petitioners on all points. On the appeal of the Government the Court of Appeals, stating that this case was controlled by the *Abercrombie* case, expressly overruled the *Abercrombie* case and its subsequent similar cases, held against petitioners on all points and reversed the judgment of the District Court.

The question presented is whether a party owning a working interest of the kind of petitioners as above set out as distinguished from a net profits interest or overriding royalty is entitled to include in its taxable income and to deduct as its depletion and expenses the income, depletion and expenses claimed by petitioners as above set out.

2. The Court of Appeals after the case was submitted asked for briefs on whether, if it should overrule *Abercrombie,* it could make such overruling prospective only and not apply it to petitioners. Such briefs were filed. The Court of Appeals, however, refused to apply it prospectively and thus held against petitioners. The question is whether, since petitioners made the two contracts of 1955 and 1956 when the *Abercrombie* case and all other cases on the point held in their favor and no cases held against them, the Court of Appeals should have made its decision overruling the *Abercrombie* case purely prospective as to petitioners. Five of the thirteen judges sitting on the case expressed grave doubts as to the wisdom of overruling *Abercrombie* and four of that five dissented and held the overruling should be made purely prospective.

STATUTES INVOLVED

The applicable statutes are sections 611(a) and 613 (a), (b) and (c) of the Internal Revenue Code of 1954. They are set out in Appendix F hereto, page 87.

STATEMENT

If what petitioners owned was net profits interest, which will be illustrated later, as distinguished from a working interest, this suit would never have been brought by petitioners. They, however, had a working interest and were liable for their proportionate part of all development and operating costs. The fact that they had Humble advance for them their part of such costs and pledged to Humble part of their portion of the oil and gas production did not make that part of the income and expenses belong to Humble. If they had borrowed money from a bank and pledged that part of the production to the bank, that

oil and gas would not be income of the bank like respondent claims it was income of Humble.

As the two contracts involved were essentially similar in all respects and as petitioner W. H. Cocke was a party to both but petitioner William H. Cocke, Jr., was a party only to the one dated January 1, 1956, we will set out here the material parts of it only. The other contract is at R. 61-85.

After reciting that the parties owned certain leasehold and unleased mineral interests in the lands involved, the contract stated:

> "WHEREAS, the parties hereto now desire to enter into a Joint Operating Agreement for the purpose of more efficiently developing, producing from, and operating the Joint Area, and in order to prevent surface and underground waste, to promote conservation, and to insure to each of the parties its fair and equitable share of the production which may be recovered from the Joint Area, and to designate one of the parties hereto as the Operator to conduct all drilling and other operations for the development and producing of the Joint Area;" (R. 87)

Contrary to the statement of the Court of Appeals in footnote 11 to its opinion (R. 176) that

> "The parties made no attempt in the agreement to allot production according to title."

the contract expressly provided:

> *"Proportionate Interest*
>
> "Whenever in this Agreement reference is made to 'Proportion,' 'Proportionate Share,' 'Proportionate Part,' 'Proportionate Interest,' or other similar desig-

nation, it shall mean the proportion that the interest of each of the parties in the Joint Area on a surface acre basis bears to the total of the interest of the parties in the Joint Area. As of the date of this Agreement, it is agreed that the Proportionate Interest of the parties is as follows:

Humble Oil & Refining Company 40.302%
The California Company .....48.06 %
Goodrich and Cocke .....11.638%" (R. 87)

Humble was appointed the Operator:

"Humble Oil & Refining Company is hereby appointed Operator of the Joint Area subject to the terms and conditions herein contained." (R. 88).

Petitioners at all times could veto the drilling of any proposed well except the first well provided for. The contract stated:

"Except as to the well hereinabove authorized, no additional wells shall be drilled at the cost and expense of the Joint Account unless mutually agreed upon by the parties hereto as to the depth and location of each such well. Operator shall secure the written approval of each of the Non-Operators before incurring against the Joint Account any item of expenditure, which item itself is in excess of Five thousand and 00/000 ($5,000.00) Dollars, except in the drilling, equipping and completing of the well hereinabove provided for and of any additional well as to which well or wells the parties mutually agree, and except in the case of expenses reasonably incurred in safeguarding life and property in case of a blowout, explosion, fire, flood, storm, hurricane, or catastrophe or other sudden emergency." (R. 94-95)

It was then provided that, if a party desired to drill a well and the others did not, he could drill it but it would be owned jointly by all parties after the drilling party had recovered 200% of its costs. (R. 97-98)

It was recognized that as to outsiders the parties would be individually liable and therefore the contract provided:

> "LIABILITY OF PARTIES
>
> "The liability of the parties hereunder shall be several and not joint or collective. Each party shall be responsible only for its obligations as set out herein and shall be liable only for its proportionate share of the cost of operation hereunder. *Nothing herein shall be construed as an assignment or transfer of the leases or an interest therein as between the parties hereto.*" (Emphasis added) (R. 102)

It then provided in reference to insuring the liability of each party:

> "INSURANCE—COMPLIANCE WITH LAWS AND REGULATIONS
>
> (a) As to all operations hereunder, Operator shall carry for the benefit and protection of the parties hereto Workmen's Compensation insurance meeting the requirements of law.
>
> (b) In conducting all operations hereunder, Operator shall comply with the Fair Labor Standards Act and all other applicable federal and state laws and applicable rules and regulations of federal and state governmental agencies having jurisdiction.
>
> (c) All damage or injury to the joint property shall be borne by the parties hereto in proportion to their interests therein. The liability, if any, of the parties hereto in damages for claims growing out

> of personal injury to or death of third parties or injury to or destruction of property of third parties resulting from the operations conducted hereunder shall be borne in proportion to their interests in the joint property, and each party individually may acquire such insurance as it deems proper to protect itself against such claims." (R. 101)

Petitioners as Non-Operators granted the Operator Humble a lien on all their interests:

> "Each Non-Operator grants to Operator a lien on its interest in the Joint Area, the production therefrom, and any and all fixtures, improvements and personal property now or hereafter located thereon to secure the payment of its proportionate part of all investments made by Operator for, and costs and expenses incurred by Operator against the Joint Account hereunder, which lien may be enforced as any other mortgage lien. Should any Non-Operator fail to pay its proportionate part of all statements rendered as provided in 'Exhibit B' within fifteen (15) days therein stipulated, same shall bear interest thereafter until paid at the rate of 6% per annum, and should such default continue for a period of ninety (90) days, Operator shall have the right at its option at any time thereafter, such default continuing, to foreclose said lien upon the interests of Non-Operator in default." (R. 92)

Under the laws of Louisiana any person that furnishes any labor or material for the joint operations has a lien on petitioners' interests in the properties. Louisiana Revised Statutes 9:4861 provided:

> "§ 4861. Privilege for labor, services or supplies
>
> Any person who performs any labor or service in drilling or in connection with the drilling of any

well or wells in search of oil, gas or water, or who performs any labor or service in the operation or in connection with the operation of any oil, gas or water well or wells, has a privilege on all oil or gas produced from the well or wells, and the proceeds thereof inuring to the *working interest* therein, and on the oil, gas or water well or wells and the lease whereon the same are located, and on all drilling rigs, standard rigs, machinery, appurtenances, appliances, equipment, buildings, tanks, and other structures thereto attached or located on the lease, for the amount due for labor or service, in principal and interest, and for the cost of preparing and recording the privilege, as well as ten per cent attorney's fees in the event it becomes necessary to employ an attorney to enforce collection. Any person who does any trucking, towing, or barging, or who makes any repairs, or furnishes any fuel, drilling rigs, standard rigs, machinery, equipment, material or supplies for or in connection with the drilling of any well or wells in search of oil, gas or water, or for or in connection with the operation of any oil, gas, or water well or wells, whether or not a producing well is obtained and whether or not such materials, machinery, equipment, services and supplies are incorporated in or become a part of the completed oil, gas or water well, has a privilege on all oil or gas produced from the well or wells and the proceeds thereof inuring to the *working interest* therein and on the oil, gas or water well or wells and the lease whereon the same are located, and on all drilling rigs, standard rigs, machinery, appurtenances, appliances, equipment, buildings, tanks and other structures thereto attached for drilling, equipment and operation of the well or lease, for the amount due for such trucking, towing, barging, repairs, fuel, drilling rigs, standard rigs, machinery, equipment, material, or supplies, in principal and interest, and for the cost of pre-

> paring and recording the privilege, as well as ten per cent attorney's fees in the event it becomes necessary to employ an attorney to enforce collection thereof. This privilege is second in rank only to the privilege granted in favor of laborers." (Emphasis added)

The contract expressly provided that all production and all property and equipment placed on the Joint Area should be owned by petitioners and the other parties in the proportion of their ownership of the joint properties.

> "Subject to the terms of Article V hereof, all production from the Joint Area and all property and equipment placed in and on same by Operator for the benefit of the Joint Account shall be owned by the parties hereto in accordance with their proportionate interest herein." (R. 91)

The contract provided that Humble should initially pay petitioners' part of all costs and recover its expenditures out of one-fourth of petitioners' production.

> "1. Goodrich and Cocke shall bear all costs in connection with the drilling of wells hereunder up to but not including the permanent tank batteries, in an amount equal to one-half of Goodrich and Cocke's proportionate interest. As to each well drilled hereunder, Humble and California shall advance Goodrich and Cocke's share of said costs, and shall be reimbursed only if such well be completed as a producer of oil, gas or other minerals, and then such reimbursement shall be only *out of one-fourth of Goodrich and Cocke's proportionate interest.* With respect to each well completed as a producer hereunder, all costs incurred in connection therewith subsequent to such completion, shall be borne by Goodrich and Cocke in an amount equal to the pro-

> portionate interest of Goodrich and Cocke in the Joint Area, provided, however, that Humble and California shall advance Goodrich and Cocke's share of all such costs, and shall be reimbursed only *out of one-fourth of Goodrich and Cocke's proportionate interest in such well.*" (R. 88-89) (Emphasis added)

It is upon this provision that the respondent seizes to deny the claims of petitioners. The respondent's position is succinctly stated in the first sentence of its Reply Brief in the Court of Appeals as follows:

> "The pivotal issue in this case is whether the allocation of depletable gross income from oil production as between carried and carrying parties is to be governed by the 'economic interest' concept, as the Government contends, or by the general principles of property law and concept of legal title, as taxpayers contend."

The District Court relying on the law as established by the Court of Appeals for the Fifth Circuit held for petitioners but the Court of Appeals below reversed its position maintained by it since the *Abercrombie* case in 1947, overruled *Abercrombie* and all its decisions following that case, and reversed the judgment of the District Court.

The Court of Appeals asked for briefs on whether, if it overruled *Abercrombie,* it could apply its change of position only prospectively as to petitioners. The petitioners in their brief pointed out that their contracts were made in 1955 and 1956 when the 1947 case of *Abercrombie* and every decision of all the courts on the points were in favor of petitioners. They pointed out that under *Linkletter v. Walker,* 381 U.S. 618, *England v. Louisiana*

State Board of Medical Examiners, 375 U.S. 411, and other cases and the Fifth Circuit's own decision in the *Linkletter* case (*United States v. Walker,* 323 F.2d 11), it had full authority and should make any overruling of *Abercrombie* purely prospective as to petitioners. That Court, with four of the thirteen judges dissenting, refused to make it prospective and applied it to petitioners. We will discuss this point more fully later in this petition.

REASONS FOR GRANTING THE WRIT

1. This petition should be granted because it is in direct conflict with the decisions of the Sixth and Tenth Circuit Courts of Appeals in *T. K. Harris Co. v. Commissioner,* 112 F.2d 76, (6th CCA) and *Reynolds v. McMurray,* 60 F.2d 843, (10th CCA), with those of the Tax Court in *J. S. Abercrombie Co. v. Commissioner,* 7 T. C. 120, and *Byron H. Farwell v. Commissioner,* 35 T. C. 454, and other Tax Court cases. As will be pointed out in detail later, both the Sixth and the Tenth Courts of Appeals decided in those two cases the same points here involved exactly contrary to the court in this case, and those cases have never been overruled or even questioned in either the Sixth or Tenth Circuit. The Tax Court in its *Abercrombie* case did the same and it has never reversed that position. Likewise in the *Farwell* case, *supra,* and other cases it has pointed out the fundamental difference between a net profits interest and a carried working interest, just as we will point out hereinafter. On the other hand the court below points out that the Internal Revenue Service's position is that there is no difference between the two, saying (R. 202):

> "Adopting the view that a carried interest is similar to a net profits interest, the Service concluded that

> the owner of a carried interest is not taxed upon income until such income is received."

2. The decision of the Court of Appeals in deciding this case on the theoretical basis of the "economic interest" concept instead of on the clear wording of the Internal Revenue Code is in direct conflict with *Hanover Bank v. Commissioner,* 369 U.S. 672; *Helvering v. Hammel,* 311 U.S. 504; *Commissioner v. Brown,* 380 U.S. 563; *Helvering v. Flaccus Leather Co.,* 313 U.S. 247; *Crane v. Commissioner,* 331 U.S. 1; *Turnbow v. Commissioner,* 368 U.S. 337. In the *Hanover Bank* case, *supra,* Mr. Chief Justice Warren stated:

> "A firmly established principle of statutory interpretation is that 'the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses'. Crane v. Commissioner, 331 U.S. 1, 6."

On the other hand, as pointed out on page 12 hereof, the Commissioner's position is that the Internal Revenue Code is to be governed by the " 'economic interest' concept" and not by the plain meaning of the Code.

3. The two other main points of this petition, namely, that *Abercrombie* should not be overruled, but, if it is, it should be overruled only prospectively, are so interrelated that we will cover them both at the same time.

When we consider that the *Abercrombie* decision and those following it are based upon this Court's decision in *Crane v. Commissioner,* 331 U.S. 1 (which decision this Court still follows), and are therefore thoroughly sound, and when we further consider the floundering efforts of those individuals from time to time in charge of the

Internal Revenue Service to promulgate regulations contrary to *Abercrombie* and their unequivocal confession in 1965 that it was impossible to promulgate such regulations, and when we consider the widespread use in the oil industry of operating agreements similar to those in this case and the uncertainty that now prevails in the entire oil industry after the action of the Court of Appeals below, we respectfully submit that this Court should grant this petition and through its decision let the Internal Revenue Service and the oil industry know just how these operating contracts are to be treated.

In 1932 the Tenth Circuit in *Reynolds v. McMurray,* 60 F.2d 843, cert. den., 287 U.S. 664, in 1934 the Ninth Circuit in *Helvering v. Armstrong,* 69 F.2d 370, and in 1940 the Sixth Circuit in *T. K. Harris Co. v. Commissioner,* 112 F.2d 76, all held just like *Abercrombie.* In 1941 General Counsel's Memorandum 22730, 1941-1 Cum. Bull. 214, 223-224 took the position contrary to *Abercrombie.* In 1946 in the Tax Court in *J. S. Abercrombie Co. v. Commissioner,* 7 T.C. 120, those at that time representing the Government took the same position as in this case, but the Tax Court held against them. The then Commissioner announced that he did not acquiesce in Tax Court's decision (1946-2 Cum. Bull. 6).

In 1947 this Court in *Crane v. Commissioner of Internal Revenue,* 331 U.S. 1, held that, where a taxpayer bought a piece of property that was subject to a mortgage which provided that the income must be applied to the mortgage, that income was taxable to the purchasing taxpayer even though he did not assume the mortgage and was not personally liable thereon.

Then in 1947 the Government's appeal in the *Abercrombie* case came before the Fifth Circuit in *Commis-*

sioner v. J. S. Abercrombie Co., 162 F.2d 338. A lessee assigned an oil lease to J. S. Abercrombie Co. and reserved a one-sixteenth working interest with the Company to pay all the expenses and recover one-sixteenth thereof out of the assignor's one-sixteenth of the production. The Fifth Circuit, relying on the *Crane* case, held the one-sixteenth of the production was not income to Abercrombie Co., citing a number of cases and then saying:

> "Cf. Crane v. Commissioner, 331 U.S. 1, 67 S.Ct. 1047 (47-1 USTC ¶9217) upon the respective contentions with reference to the assignors not being personally liable for any of the expenditures made on their behalf by the operators."

In 1949 the Commissioner withdrew his 1946 non-acquiescence in *Abercrombie* and announced his acquiescence. 1949-1 Cum. Bull. 1. In that same 1949 the District Court at Houston, Texas in *Foster v. United States*, 85 F. Supp. 447, a case handled by the undersigned, followed *Abercrombie* and the Government did not appeal.

At this point, *i.e.*, in 1955 and 1956, the petitioners executed the two operating contracts now before the Court.

In 1959 the Fifth Circuit reaffirmed and followed *Abercrombie* in *Prater v. Commissioner*, 273 F.2d 124, and the Government did not appeal.

In 1960 those then in the Commissioner's office proposed a new set of regulations contrary to *Abercrombie*. 25 Federal Register 3761. The following is a part of the proposed regulations:

> "§ 1.612-4. Charges to capital and to expenses in case of oil and gas wells.

(a) Option with respect to intangible drilling and development costs.

"(1) In accordance with section 263(c), the operator (one who holds the *working or operating rights* and is obligated for the costs of production either as a fee owner or under a lease or any other form of contract creating working or operating rights) may, at his option, deduct as expenses the intangible drilling and development costs paid or incurred by him in the development of oil and gas deposits to the extent such costs are attributable to his share of the total of all operating mineral interests in the well. To the extent such costs are not so attributable, but are attributable to the fraction of the total operating mineral interests held by others, they are not subject to the option and must be capitalized.

"(2) Where the operator is assigned all the operating rights *for the 'complete pay-out period'* in a well (or wells), he will be considered, for purposes of sub-paragraph (1) of this paragraph as having the entire operating mineral interest in such well (or wells). Similarly, where the operator is assigned only a fraction of the operating rights for the 'complete pay-out' period he will be considered as having such fraction of the entire operating mineral interests in such well (or wells). * * * The 'complete pay-out period' means the period ending when the gross income attributable to all of the operating mineral interests in the well (or wells) equals all expenditures for drilling and development (tangible and intangible) of such well (or wells) plus the costs of operating such well (or wells) to produce such amount. * * *" (Emphasis added)

The Commissioner stated he would consider any comments pertaining to the matter. Paragraph (2) of the proposed regulation would have abrogated the *Abercrom-*

bie rule, but in the light of all the objections the Commissioner in 1965 completely eliminated paragraph (2) and left the *Abercrombie* rule in full effect. T. D. 6836, 1965-2 Cum. Bull. 182. On this point we copy the following from page 5 of the Government's supplemental brief in the Court of Appeals in this case:

> "On the basis of a thorough study of the carried interest problem which was then conducted, it was decided that any further attempt to settle the problems in this area satisfactorily by Regulations based on the 'pay-out period' concept would be doomed to failure because it was impossible to articulate detailed rules that could satisfactorily cover the great variety of arrangements that could be adopted contractually in the carried interest context.
>
> "Accordingly, it was decided to abandon attempts to specify in the Regulations how the carrying party's share of expenses would be determined, and the final Regulations were issued on July 14, 1965, without the provisions dealing with situations involving carried interests, T. D. 6836, 1965-2 Cum. Bull. 182."

In the meantime between 1960 and 1965 the Government itself relied upon the *Abercrombie* case in *Weinert's Estate v. Commissioner,* 294 F.2d 750, in the Fifth Circuit. We quote the following from the opinion below in this case (R. 203):

> "Moreover, in 1961 the Service itself even relied on *Abercrombie* in the case of *Weinert's Estate.* We quote from the opinion in that case:
>
> "Before the Court the Commissioner relies: (1) on Abercrombie and Prater to show that the carrying party's advances were a loan; . . . ." 294 F.2d 752.

In 1962 the Fifth Circuit in *Sowell v. Commissioner*, 302 F.2d 177, through Judges Wisdom, Brown, and Bell reiterated *Abercrombie* in the strongest of languages:

> "Whatever else may be said about Abercrombie and Prater, there can be no question as to the soundness of this Court's position in those cases that oil and gas income is constructively received by a taxpayer when it is applied in payment of a debt for which his economic interest is liable. And see Commissioner of Internal Revenue v. Slagter, 7 Cir., 1956, 238 F.2d 901; Whitwell v. Commissioner, 5 Cir. 1958, 257 F.2d 548."

> "Summarizing, the common sense view of the situation coincides with the legal technicalities: 'Income is taxable to the owner of the property producing same.' Commissioner of Internal Revenue v. J. S. Abercrombie Co., 5 Cir., 1947, 162 F.2d 338."

The opinion in that case showed it was based upon this Court's opinion in the *Crane* case, the Court saying, 302 F.2d 180:

> "In both cases the income was paid to a mortgagee under an existing obligation for which the property was liable. See Crane v. Commissioner, 1947, 331 U.S. 1, 67 S.Ct. 1047, 91 L.Ed. 1301, indicating that when a person purchases property subject to an existing mortage debt, he constructively receives income paid to reduce the mortgage although he has not assumed personal liability on the mortgage and was not initially responsible for placing the mortgage on the property."

In 1963, before he withdrew in 1965 his regulations proposed in 1960, the Commissioner in a halfhearted way

announced in 1963-2 Cum. Bull. 6 that he did not acquiesce in the *Abercrombie* case.

It is obvious that the court below adopted in toto the view of the Commissioner that a so-called carried interest, such as in *Abercrombie* and in this case, was merely a net profits interest, and on that basis decided this case. It said (R. 202):

> "Adopting the view that a carried interest is similar to a net profits interest, the Service concluded that the owner of a carried interest is not taxed upon income therefrom until such income is received."

The fallacy of such a position is recognized when a net profits interest is seen. A typical net profits interest was involved in *Kirby Petroleum Company v. Commissioner*, 326 U.S. 599, which the undersigned handled before this Court. Kirby owned the fee title to some land and leased it to Humble Oil & Refining Company and reserved a royalty of one-sixth of the gross production and by a supplementary agreement it was provided:

> "Second Party (i.e. Kirby), subject to the terms and provisions hereof and in the manner herein provided, shall be entitled to receive twenty per cent (20%) of the net money profits realized by First Party (Humble) from its operations under and by virtue of the lease referred to above."

This Court held Kirby was entitled to take depletion on the net amount it received. Since Kirby had nothing to do with the operations and had no title to any of the equipment, it made no claim to depletion on 20% of the gross income.

A similar net profits agreement was in *Burton-Sutton Oil Co., Inc. v. Commissioner,* 328 U.S 25. Gulf Refining Company owned some leases and transferred them to another party, and, as shown in 3 T.C. 1187, 1190, the transfer provided:

> "3. After Grantee has met the underlying and overriding obligations referred to in paragraph 2 hereof and has been reimbursed out of the proceeds of the oil and gas produced for all such costs and expenses of operating upon said property as defined below, Grantee shall account to and pay Grantor 50% of the remaining portion of said proceeds of the oil and/or gas produced and sold from said land."

Here again Gulf had nothing to do with the operations and its only taxable income was the actual cash it received.

The holder of a net profits interest is just like the holder of a landowner's royalty under a lease or the owner of an overriding royalty and is entirely different from the holder of a so-called carried interest as abundantly shown above.

The court below strongly relied upon *United States v. Thomas,* 329 F.2d 119, (1964) in which the Ninth Circuit overruled its prior decision in *Helvering v. Armstrong,* 69 F.2d 370, and disapproved of *Abercrombie* and the other cases along that line. Actually there was no necessity for the Ninth Circuit even to discuss those cases as what was involved was a pure net profits agreement. The taxpayers and others, referred to as Quality, owned a 30% interest in some leases and Richfield owned 70%. Under a contract between them Richfield was given "the sole and exclusive right" to develop and operate the properties

and pay Quality 30% of the net profits. We quote from the opinion:

> "Appellees timely filed claims for refund for overpayments and claimed therein that they were entitled to compute percentage depletion on the basis of a share in the gross income from the oil and gas operations.
>
> * * *
>
> "The broad question presented on the appeal is the amount which the appellees are entitled to use as a base for computing the percentage depletion."

The court properly held that they were entitled to take depletion only on the actual cash they received and not on 30% of the gross income from the property. That it was a pure net profits arrangement is shown by the fact that Richfield was given the exclusive right to operate the properties and it was then provided (329 F.2d 125):

> "22. Title to all buildings, structures, improvements, facilities, equipment, materials and supplies constructed, installed or placed on the joint lands in connection with joint operations hereunder, shall be and remain in Operator and Quality shall have no interest therein, except that Quality shall have the right to have the joint account credited with the value of any thereof removed from the joint account, as provided for in Exhibit 'A' hereof."

There was no necessity for it even to refer to *Abercrombie* or to overrule its *Armstrong* case, and its remarks thereon were pure dicta. Even so, Circuit Judge Chambers dissented.

The court below in footnote 20 to its opinion cites a whole page of articles in law reviews and tax institutes

(R. 200) and says that they presage the overruling of *Abercrombie.* They were cited by the Government in its brief to that effect. While we have not had access to all of them, we state that they for the most part do nothing but merely bring down to date the latest rulings on the matter. Some of them that advocate overruling *Abercrombie* were written by parties who were personally interested in killing *Abercrombie.* From over forty-eight years in handling tax and oil businesses and litigation, we know two classes that are against *Abercrombie.*

First, the large oil companies that are often the operator in these cases. They want to get the depletion and depreciation deductions that they cannot get under *Abercrombie,* just like Humble took them in this case contrary to *Abercrombie.* (R. 21-38). (Humble's tax employees' testimony).

Second, an oil lease man gets together a block of leases but does not want to drill a wildcat well. He goes to a man in a high tax bracket and gets him to take an assignment of a one-half interest in the leases and to "carry" the lease man for the other one-half. If *Abercrombie* is done away with, he can tell the man that he can set off against his highly taxable income his drilling expenses before he gets enough production to repay him and thus he will materially reduce his taxes and his drilling outlays will be materially reduced. We know that those deals are made. Is it not natural that tax people representing such lease men very strongly favor overruling *Abercrombie?*

The opinion below cites and quotes from a writer named Hambrick. (R. 175, 192 and 203). The following quotation from Hambrick (R.175-176) shows, in our opinion, that Professor Hambrick knew very little if anything about the oil business or *Abercrombie*:

> "In fact, Professor Hambrick argues that *Abercrombie* did not present a true carried interest at all, bebecause the agreement in that case provided for a *permanent* shift to the carrying party of the obligation to put up operating costs. His thesis is that a true carried interest terminates after a payout period during which the carrying party recoups the investment of drilling and development costs. After the recoupment, the carrying and carried parties are both responsible for costs of operating. Hambrick thus concludes that the *Abercrombie* agreement in reality provided for a 1/16 net profits interests per se the *Burton-Sutton* situation, in favor of the 'carried party'."

Of course, the whole matter of payout period brings on insoluble problems. In its proposed regulations in 1960 the Service tried to use the standard of a payout period, that is, the period ending when the operator had recovered the cost of drilling the wells, and found it presented so many difficulties the proposed regulations had to be abandoned.

One of the authors cited by the court below is Frank B. Appleman, "Oil and Gas Tax Law—1964 Critique" in the Fifteenth Annual Institute on Oil and Gas Law of the Southwestern Legal Foundation 457, 469-471. (R. 200). We will simply give Appleman's statement as to how the Service has switched back and forth on *Abercrombie*. After referring to *Abercrombie*, he states:

> "It should be noted, parenthetically, that there have perhaps been more acquiescences announced and withdrawn, as well as non-acquiescences announced and withdrawn, in this case than in any other case in tax history."

Certain very pertinent questions immediately rise in one's mind:

a. Where does the idea that petitioners must have been personally liable to the operator for their part of the expenses come from? The debtors' prisons no longer exist and a man's debt is still a debt although his creditor may go against only certain assets. Texas Uniform Commercial Code, §3-105(1)(2)(b); Art. 3832-3836, Texas Revised Civil Statutes exempting from execution a great list of properties.

b. If petitioners had borrowed the expense money from a bank and given it a right to collect its money only out of their oil, it has never been held that their part of the oil was taxable income to the bank.

c. The California Company was one of the non-operators but had to pay Humble its part of all the expenses. Why should the Government say that its part of the oil was taxable to it and not to Humble and yet say just the contrary to petitioners?

It may be noted that the Court below, while deciding this case on the "economic interest" concept urged by the Government, rejected the "economic interest" concept on May 1, 1968, (three months before deciding this case) in *Louisiana Land and Exploration Company v. Donnelly*, 394 F.2d 273. The taxpayer held an 8⅓% pure net profits royalty interest and claimed the right to deduct the Louisiana State severance taxes paid on 8⅓% of the gross revenue and not just those on the 8⅓% of the net profits. The Court of Appeals held for the taxpayer purely and simply because the Louisiana Courts held that under local law the taxpayer owned 8⅓% of the gross production. The two cases cannot be reconciled.

d. Turning to the question of whether the court below erred in not making the overruling of *Abercrombie* prospective as to petitioners, four of the thirteen justices dissented. Furthermore, the court's basing its refusal on the Service's treatment of *Abercrombie* is wholly untenable. If its holding should be sustained, then no matter how many times the courts should hold against the Service, no one could rely on those decisions if the Service simply non-acquiesced in them. We submit that such a view is contrary to the views of this Court expressed in *Linkletter v. Walker,* 381 U.S. 618; *England v. Louisiana State Board of Medical Examiners,* 375 U.S. 411, and other cases.

While the years 1957 and 1958 are the only years involved in this case for petitioners, these properties are still actively producing and all of petitioners' tax years subsequent thereto will be controlled by this case.

CONCLUSION

Mr. Justice Black during the argument of the *Kirby Petroleum Company* case, *supra,* asked the undersigned if it were not true that either Kirby or Humble would get the depletion involved and we said that was true. The same is true in this case. Either the petitioners or Humble are entitled to the items claimed by the petitioners.

This is one of the most important cases involving the whole oil industry and the latter is waiting to see the final result. The Service has thrown up its hands in trying to solve the questions by regulations. When it withdrew in 1965 its 1960 proposed regulations, it stated on July 15, 1965, in T.I.R. - 749:

> "However, the Revenue Service said that, in appropriate cases, it will entertain requests for rulings on the eligibility of a taxpayer to deduct as expenses intangible drilling and development costs paid or incurred by him. In such rulings, the decision of the Revenue Service will depend on the particular facts and circmustances of each individual case."

We submit that taxpayers should not be forced to submit their case to the Service before acting and this Court should hear this case and announce the guiding principles involved.

Petitioners, therefore, respectfully pray that this petition for writ of certiorari be granted.

Respectfully submitted,

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APPENDIX A

IN THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF TEXAS, HOUSTON DIVISION

W. H. COCKE AND TULA STOKES COCKE
WILLIAM H. COCKE, JR. AND
BEULAH R. COCKE, *Plaintiffs,*

v.

UNITED STATES OF AMERICA, *Defendant.*

CIVIL ACTION NO. 65 H 117
CIVIL ACTION NO. 65 H 118

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This consolidated cause came on to be heard and the plaintiffs and the defendant appeared by their attorneys and the court having considered the pleadings, the stipulations, the admissions on file and the evidence and the briefs and argument of counsel for the plaintiffs and defendant, makes the following findings of fact and conclusions of law:

FINDINGS OF FACT

1. This is a consolidated cause of two causes to recover from the defendant income taxes paid to the defendant under the provisions of the Internal Revenue Code of 1954.

Plaintiffs W. H. Cocke and wife sue to recover certain income taxes paid by them to the defendant for the year 1958, and plaintiffs William H. Cocke, Jr. and wife sue to recover certain income taxes paid by them to the defendant for the year 1957.

2. On October 12, 1955, the plaintiffs Cocke and wife, R. H. Goodrich, and Humble Oil & Refining Company (herein referred to as "Humble") owned certain working and mineral interests in certain oil and gas properties in St. Martin Parish, Louisiana, which will be referred to as the "Goodrich-K properties." On that date the said parties executed an operating agreement under which Humble would be the operator. The contract provided in part:

> "Operator shall advance all monies necessary for conducting the operations hereunder and shall reimburse itself currently for Non-Operator's share of expenses and charges to the Joint Account out of one-half (1/2) of Non-Operator's proportionate interest in the current production."

This contract was in effect in reference to these properties during the year 1958.

3. On January 1, 1956, the plaintiffs Cocke and wife, and Cocke, Jr. and wife, R. H. Goodrich, H. R. Goodrich, Humble, and the California Company (herein called "California") owned certain working and mineral interests in certain oil and gas properties in Iberia Parish, Louisiana, which will be referred to as the "Bayou Postillion properties." On that date the said parties executed an operating agreement under which Humble would be the operator. The contract provided in reference to Humble, California and the two Goodriches and the two Cockes as follows:

> "1. Goodrich and Cocke shall bear all costs in connection with the drilling of wells hereunder up to but not including the permanent tank batteries, in an amount equal to one-half of Goodrich and Cocke's proportionate interest. As to each well drilled hereunder, Humble and California shall advance Goodrich and Cocke's share of said costs, and shall be reimbursed only if such well be completed as a producer of oil, gas or other minerals, and then such reimbursement shall be only out of one-fourth of Goodrich and Cocke's proportionate interest. With respect to each well completed as a producer hereunder, all costs incurred in connection therewith subsequent to such completion, shall be borne by Goodrich and Cocke in an amount equal to the proportionate interest of Goodrich and Cocke in the Joint Area, provided, however, that Humble and California shall advance Goodrich and Cocke's share of all such costs, and shall be reimbursed only out of one-fourth of Goodrich and Cocke's proportionate interest in such well."

This contract was in effect in reference to these properties during the year 1957.

4. By the execution of those two operating agreements neither the plaintiffs nor any other party thereto transferred to the operator or any other party any part of their interest in the minerals. The plaintiffs and all other parties to the operating agreements remained personally liable to all outside parties involved in the operations of the properties, such as laborers, equipment suppliers, and third parties injured by the negligence of the operator, and they were liable as between themselves for their proportionate part of all such liabilities to such outside parties. This proportionate interest was defined in each of the operative agreements. For example, the agreement of October 12, 1955, provided:

"Whenever, in this Agreement, reference is made to 'proportion,' 'proportionate share,' 'proportionate part,' or 'proportionate interest,' or other similar designations, it shall mean the proportion that the working interest of each of the parties in the Joint Tracts bears to the total of the working interest in the Joint Tracts of the parties hereto."

The operating agreement of January 1, 1966 provided:

"Whenever in this Agreement reference is made to 'Proportion,' 'Proportionate Share,' 'Proportionate Part,' 'Proportionate Interest,' or other similar designation, it shall mean the proportion that the interest of each of the parties in the Joint Area on a surface acre basis bears to the total interest of the parties in the Joint Area."

As to the liabilities of the parties the contracts provided:

"The Joint Tract shall not be operated hereunder as a partnership venture, and the liability of the parties hereunder shall be several and not joint or collective. Each party shall be responsible only for its obligations as set out herein and shall be liable only for its proportionate share of the cost of operations as set out hereunder." (Contract of October 12, 1955).

"The liability of the parties hereunder shall be several and not joint or collective. Each party shall be responsible only for its obligations as set out herein and shall be liable only for its proportionate share of the cost of operations hereunder. Nothing herein shall be construed as an assignment or transfer of the leases or an interest therein as between the parties hereto." (Contract of January 1, 1956).

As to each party's ownership of the oil and gas and its proceeds, the contracts provided:

> "Each of the parties hereto shall share in the production from the Joint Tracts in the proportion that the interest of each of the parties in the Joint Tracts bears to the total of the interest in the Joint Tracts of the parties hereto." (Contract of October 12, 1955).
>
> "Subject to the terms of Article V hereof, all production from the Joint Area and all property and equipment placed in and on same by Operator for the benefit of the Joint Account shall be owned by the parties hereto in accordance with their proportionate interest herein." (Contract of January 1, 1956).

5. For the year 1958 the plaintiffs Cocke and wife in their income tax return for 1958 took into account their entire proportionate part of the gross income from their Goodrich-K properties and Bayou Postillion properties and computed their depletion on that basis; deducted their entire proportionate part of the intangible drilling expenses and other operating expenses in reference to those properties; deducted their proportionate part of the production taxes applicable to their interest in the properties; and computed their depreciation on their entire proportionate part of the depreciable property. The defendant held that they should include in their gross income only the amounts not retained by Humble out of their income under said two operating contracts; that they were not allowed to deduct any of the intangible drilling costs or other expenses that had been paid by Humble; that they should not be allowed to deduct any part of the production taxes applicable to their interest in the production except the amount not retained out of their income by Humble; that they were not en-

titled to deduct any depreciation on any of the depreciable equipment on said properties; and that their allowance for depletion should be computed only in reference to the gross income not retained by Humble. The defendant on account of said action assessed the tax for which the plaintiffs Cocke and wife sue in this cause. Said plaintiffs paid that tax and the interest thereon as set out in their complaint and on the date set out therein.

6. For the year 1957 the plaintiffs Cocke, Jr. and wife in their income tax return for 1957 took into account their entire proportionate part of the gross income from their Bayou Postillion properties, and computed their depletion on that basis; deducted their entire proportionate part of the intangible drilling expenses and other operating expenses in reference to those properties; and computed their depreciation on their entire proportionate part of the depreciable property. The defendant held that they should include in ther gross income only the amounts not retained by Humble out of their income under the operating contract of January 1, 1956; that they were not allowed to deduct any of the intangible drilling costs or other expenses that had been paid by Humble; that they were not entitled to deduct any depreciation on any of the depreciable equipment on said properties, and that their allowance for depletion should be computed only in reference to the gross income not retained by Humble. The defendant on account of said action assessed the tax for which the plaintiffs Cocke, Jr. and wife sue in this cause. Said plaintiffs paid that tax and the interest thereon as set out in their complaint and on the date set out therein.

7. It is stipulated by the plaintiffs and the defendant that if it should be held that the plaintiffs were correct in treating the items set forth in paragraphs 5 and 6 above

as stated therein, the plaintiffs shall be entitled to recover from the defendant the amounts for which they sue in this consolidated cause.

8. Within less than two years after the dates on which the plaintiffs, respectively, paid said taxes and interest, the plaintiffs, respectively, filed with the United States District Director of Internal Revenue for the Austin District of Texas their claims for refund to them of said taxes and interest, all in accordance with the laws of the United States and the rules and regulations prescribed by the Commissioner of Internal Revenue and the Secretary of the Treasury. In said claims for refund the plaintiffs, respectively, claimed that said taxes and interest should be refunded to them on the same grounds and for the same reasons as are set forth in their respective complaints in this cause as the grounds and reasons upon which they should recover said taxes and interest from the defendant.

On or about February 11, 1965, the Commissioner of Internal Revenue, acting through the District Director of Internal Revenue for the Austin District of Texas, mailed by certified mail to the plaintiffs, respectively, notice of the disallowance by him of their said respective claims for refund.

CONCLUSIONS OF LAW

1. This court has jurisdiction of the subject matter of, and parties, under this consolidated cause.

2. This consolidated cause involves the questions as to the rights of parties having a carried interest in oil and gas properties that have been litigated and decided in favor of the taxpayers in Commissioner of Internal Revenue v.

J. S. Abercrombie Co., 162 F.2d 338 (5 C.A.); Foster v. United States, 85 F. Supp. 447 (U. S. District Court, Houston Division, opinion by Chief Judge Kennerly); and Prater v. C.I.R., 273 F.2d 124 (5 C.A.). See Sowell v. C.I.R., 302 F.2d 177 (5 C.A.), where the court at pages 180 and 181 reaffirmed its holding in C.I.R. v. J. S. Abercrombie Co., supra. The interests of plaintiffs and the other non-operators in the properties covered by the two operating contracts were not what are commonly designated as net profits interests.

3. The Commissioner of Internal Revenue erred in making the changes, referred to in paragraphs 5 and 6 of the foregoing findings of fact, that he did in connection with the income taxes for the plaintiffs Cocke and wife for 1958 and the plaintiffs Cocke, Jr. and wife for 1957.

4. The plaintiffs, respectively, are entitled to recover of and from the defendant the overpayment of income taxes and interest thereon in the amounts set forth in their respective complaints with interest thereon at the rate of 6% per annum from the date such payments were paid by the plaintiffs, respectively, to the defendant as set forth in their respective complaints.

5. Plaintiffs are each entitled to recover of and from the defendant all costs in this cause allowed by law.

Signed this 29th day of March, 1966.

JOE INGRAHAM
United States District Judge

APPENDIX B

IN THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF TEXAS, HOUSTON DIVISION

Civil Action No. 65 H-117
Civil Action No. 65 H-118

(Filed March 29th, 1966)

W. H. COCKE and TULA STOKES COCKE
WILLIAM H. COCKE, JR. and BEULAH R. COCKE,
Plaintiffs,

v.

UNITED STATES OF AMERICA, *Defendant.*

JUDGMENT

Be it remembered, that the above numbered, entitled and consolidated cause came on to be heard on March 14, 1966, and came the plaintiffs by their attorneys and came the defendant, the United States of America, by its attorney, and all parties announced ready for trial. A jury having been waived, the matters of fact and of law were by agreement submitted to the Court. The Court, after considering the pleadings, the evidence, the stipulations of the parties and argument of counsel, is of the opinion and finds the facts and law in favor of the plaintiffs as set forth in the Court's findings of fact and conclusions of law filed in this cause. In accordance therewith, it is

ORDERED, ADJUDGED AND DECREED that the plaintiffs, W. H. Cocke and Tula Stokes Cocke, do have and recover judgment against the defendant, United States of America, for the sums of $2,890.30 and $904.06 with interest thereon at the rate of 6% per annum from July 8, 1964; and it is further

ORERED, ADJUDGED AND DECREED that the plaintiffs, William H. Cocke, Jr., and Beulah R. Cocke, do have and recover judgment against the defendant, United States of America, for the sums of $2,466.77 and $919.59 with interest thereon at the rate of 6% per annum from July 29, 1964.

It is further ordered that plaintiffs recover of and from the defendant all costs in said consolidated cause allowed by law.

Signed this 29th day of March, 1966.

JOE INGRAHAM
United States District Judge

APPROVED:

HOMER L. BRUCE
Homer L. Bruce
Attorney for Plaintiffs

APPROVED AS TO FORM:

JOHN H. BAUMGARTEN
John H. Baumgarten
Assistant United States Attorney
Attorney for Defendant

APPENDIX C

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NO. 23,963

UNITED STATES OF AMERICA,
Appellant,

versus

W. H. COCKE, ET AL.,
Appellee.

Appeals from the United States District Court for the Southern District of Texas

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(July 31, 1968)

Before BROWN, Chief Judge, TUTTLE*, WISDOM, GEWIN, BELL, THORNBERRY, COLEMAN, GOLDBERG, AINSWORTH, GODBOLD, DYER, SIMPSON and CLAYTON, Circuit Judges.**

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*Subsequent to oral argument on hearing en banc, January, 1968, at Houston, Texas, Judge Tuttle has become a Senior Judge. 28 U.S.C. § 371(b). As he participated in that hearing, he is competent to participate in the determination thereof. 46 U.S.C. § 46(c); *Allen v. Johnson,* 5 Cir. 1968, 391 F.2d 527 (en banc).

**This is one of six cases submitted en banc to the Court at Houston. The cases are set out in *Allen v. Johnson, supra,* 391 F.2d at 528 (fn. 1 of the opinion) and in *Miller v. Amusement Enterprises, Inc.,* 5 Cir. 1968, 394 F.2d 341, 341 (en banc) (at *).

GOLDBERG, Circuit Judge: This case — involving questions of oil and gas depletion, depreciation, and intangible drilling and development costs[1] — provides a setting for our occational departure from the doctrine of stare decisis. The taxpayer argues, and the government concedes, that the disposition of the present case depends upon whether the doctrine of *Commissioner v. J. S. Abercrombie Co.*, 5 Cir. 1947, 162 F.2d 338, stands or falls. Because the Court believed the question to be one of exceptional importance to which uniformity of decision is vital, a hearing en banc was ordered pursuant to Fifth Circuit Court Rule 25(a).[2] We now conclude that our decision in *Abercrombie* must be overruled.

I.

Abercrombie represents one form of a carried interest transaction in the field of oil and gas. In any carried interest transaction, one of the owners of the working interest in property is willing to advance the funds necessary for drilling of wells and development of production of oil or gas, and to look only to the other owner's share of production for the other owner's contribution to such costs. The party who puts up the money is called the carrying party because he risks his entire

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[1]Pertinent sections of the Internal Revenue Code of 1954 are set out in an Appendix to this opinion.

[2]"Rule 25(a). En Banc Hearing or Rehearing.

"(a) *When Hearing or Rehearing en Banc Will be Ordered.* A majority of the circuit judges who are in regular active service may order that an appeal or other proceeding be heard or reheard by the court of appeals en banc. Such a hearing or rehearing is not favored and ordinarily will not be ordered except (1) when consideration by the full court is necessary to secure or maintain uniformity of its decisions, or (2) when the proceeding involves a question of exceptional importance."

investment against the possibility that there will not be enough production to reimburse him for his costs. The other party is called the carried party because he takes no risks. The carried party agrees to wait until the carrying party has recouped his drilling and development costs out of production before he takes any payments on his share. The carried party is not personally liable for any costs and loses nothing if there is no production.

The courts and the commentators have recognized three types of carried interests. In the *Manahan* type,[3] the carried party originally owns all of the working interest and assigns the entire interest to the carrying party, who is obligated to drill and develop a well or wells. This assignment is subject to a right of reversion of a portion (typically one-half) of the working interest to the carried party if and when the drilling and development costs are recouped by the carrying party. After this reversion, income and expenses are shared by carried and carrying parties according to their proportionate shares of the working interest.[4]

In the *Herndon* type,[5] the carried party originally owns all of the working interest and assigns half (or some other share) of the working interest to the carrying party, who is obligated to drill and develop. The carried party also assigns to the carrying party an oil production payment covering his retained working interest. This assignment ends only when the carrying party has recouped his drilling and development costs.

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[3]Named for *Manahan Oil Company*, 1947, 8 T.C.

[4]See Bullion, "A New Look at Tax Aspects of Oil and Gas Sharing Arrangements," *Southwestern Legal Foundation Eighth Annual Institute on Oil and Gas Law and Taxation* 603, 604 (1957).

[5]Named for *Herndon Drilling Company*, 1946, 6 T. C. 628.

It has been held that during the period of the recoupment the carried party in a *Manahan* or *Herndon* carried interest gets no income and no deductions for depletion or depreciation, and that all income and deductions go to the carrying party. See *Weinert's Estate v. Commissioner*, 5 Cir. 1961, 294 F.2d 750. See also Breeding, "The Trend in Carried Interest Cases," 17 *Southwestern Law Journal* 242 (1963); Galvin, "The 'Ought' and 'Is' of Oil-and-Gas Taxation," 73 *Harvard Law Review* 1441, 1492-94 (1960); Bullion, *supra* note 4, at 606-607.[6]

The third form of carried interest is represented by *Commissioner v. J. S. Abercrombie Co.*, 5 Cir. 1947, 162 F.2d 338. In that case the carried party had assigned all but 1/16 of its working interest to the carrying party. The carrying party was to drill and operate the wells, to pay all costs and expenses out of production, and to pay to the carried party 1/16 of "operating profits" (income after the deductions for costs and expenses had been made). In the calendar year 1941 there was nothing to pay to the carried party under the agreement because deductions for costs and expenses exceeded income. The carrying party's tax return, however, did not include as income 1/16th of the gross proceeds, as the carrying party claimed that such income was attributable to the carried party. The Commissioner contended that the corried party had retained only a 1/16 interest in *net* profits, and that none of the gross profits used by the carrying party in recouping its outlays was income taxable to the carried party.

In reversing for the carrying party, we stated the following:

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[6]Mr. Bullion explains a difference in tax treatment of depletion between *Manahan* and *Herndon* types which is not in issue here.

> "In some instances the law may look through form to substance to get to the right of a controversy, but in ordinary cases tax consequences under federal law often depend upon property rights under local law, which in turn may be fixed by agreements between owners of the property . . . .
>
> . . . "[O]ur decision is controlled by the fundamental principle that income is taxable to the owner of the property producing the same, and that an assignment in anticipation of such income is ineffective to avoid taxation thereof to the real owner. The economic reality of the transaction was that the assigning co-owners mortgaged their interest to their operating co-owner; and by so doing they not only reaped the benefit of development but acquired an undivided one-sixteenth interest in valuable physical equipment placed on the property by the operators." 162 F.2d at 339, 340.

We held in *Abercrombie* that the carried party's retention of a 1/16 interest in "operating profits" meant that 1/16 of all gross income, no matter whether paid out to the carried party or retained and used by the carrying party for drilling or development costs or expenses, was income to the carried party. Twelve years later, in *Prater v. Commissioner*, 5 Cir. 1959, 273 F.2d 124, we "followed Abercrombie to its logical conclusion and allowed a carried party [in an *Abercrombie* transaction] to deduct his attributive [fractional] . . . share of the costs of development and operation." *Weinert's Estate v. Commissioner, supra*, 294 F.2d at 758.[7]

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[7]The carrying party in *Prater* had outside financing and the carried party joined in a mortgage of the entire working interest to secure this financing. We held in part, "[I]f one has an economic interest in oil in place, neither the fact, that that interest is pledged to secure the return of advances made on his account by others, nor the fact, that the owner is not personally liable

Although neither the *Abercrombie* nor the *Prater* opinion clearly explains the rationale of *Abercrombie*, a two-pronged argument has since been advanced to support the result. First, as the appellee argues here, it may be argued that the *Abercrombie* transaction was a loan from the carried to the carrying party of 1/16 of the funds necessary to develop and operate the wells. The loan could be repaid only out of the carried party's share of production. The production which went towards repaying any of the loan would be income to the carried party on the familiar theory that the nondonative payment of a debt by a third party is income to the debtor. Int. Rev. Code of 1954, §61(a)(12).

The second prong of this argument distinguishes an *Abercrombie* situation from other carried interest cases by the situs of title. Unlike *Manahan* and *Herndon*, in *Abercrombie* and *Prater* the carried party did not assign to the carrying party either title to, or oil production payments from,[8] his retained portion of the working interest. Each gave the carrying party merely the right to recoup drilling and development costs out of production before making any payments to the carried party.[9]

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for the repayment of the advances, changes the legal situation as to the ownership of the interest and the income and the right to deduct the expenses attributable to his share." 273 F.2d at 125.

[8]"It is clearly true, as already indicated, that an oil payment, like royalty, is an interest in property, an interest in realty, an interest in the minerals in place." *Commissioner v. Hawn*, 5 Cir. 1956, 231 F.2d 340, 343.

[9]The distinction is skeptically stated in Breeding, *supra*, at 248: "The only distinction between the latter case [*Abercrombie*] and the other two [*Manahan* and *Herndon*], and this distinction seems more formal than real, is that in *Abercrombie* the assignor retained or held title to the working interest; whereas, the arrangement was accomplished in the other two cases by a temporary assignment of title."

Despite attempted distinctions, the *Abercrombie* and *Prater* holdings conflict with the view, taken in other carried interest transactions, that only income actually payable to the carried party is taxable to the carried party. Fundamental to both *Manahan* and *Herndon* is that no income which, under the carried interest agreement, is retained by the carrying party and used to recoup drilling and development costs (as opposed to operating expenses) is taxable to the carried party. Moreover, one year before *Abercrombie* the Supreme Court decided two cases, *Burton-Sutton Oil Co. v. Commissioner,* 1946, 328 U.S. 25, 66 S.Ct. 861, 90 L.Ed. 1062, 162 A.L.R. 827, and *Kirby Petroleum Co. v. Commissioner,* 1946, 326 U.S. 599, 66 S.Ct. 409, 90 L.Ed. 343, which cast further doubt on the loan-title rationale (although seemingly they were used for support in the *Abercrombie* opinion). These cases stated that for tax purposes an interest in net proceeds is a depletable interest in the oil; thus, receipt of such proceeds is taxable only to the recipient. Implicit in the *Burton-Sutton* opinion is the principle that before the break-even point is reached, gross income is reported by the one who, through the production contract, actually receives it.[10]

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[10]According to Professor Hambrick, the only difference between the *Abercrombie* net profits interest and the net profits interest in *Burton-Sutton* was that the "carried party" in *Abercrombie* retained title to 1/16 of the leasehold, while the assignor in *Burton-Sutton* had retained only a net profits interest. In fact, Professor Hambrick argues that *Abercrombie* did not present a true carried interest at all, because the agreement in that case provided a *permanent* shift to the carrying party of the obligation to put up operating costs. His thesis is that a true carried interest terminates after a payout period during which the carrying party recoups the investment of drilling and development costs. After the recoupment, the carrying and carried parties are both responsible for costs of operating. Hambrick thus concludes that the *Abercrombie* agreement in reality provided for a 1/16 net profits

With this discussion of legal background, we turn to the facts of the present case.

II.

The taxpayers, William H. Cocke, Sr., and Tula Stokes Cocke, his wife, and William H. Cocke, Jr., and Bula H. Cocke, his wife, were residents of Houston. The Cockes were involved in two agreements for the drilling and production of oil. We describe each briefly.

In the first, Cocke, Sr., R. H. Goodrich, and Humble Oil and Refining Company owned working interests in mineral leases and unleased mineral interests in St. Martin Parish, Louisiana, known as the "Goodrich K" properties.[11]

On October 12, 1955, Humble, Goodrich, and Cocke, Sr., entered into a joint operating agreement among themselves to accomplish the drilling and development of the Goodrich K properties. Humble was designated Operator, with control of exploration, drilling, and production of oil. Humble was given a 50 per cent interest in production.

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interest, per se the *Burton-Sutton* situation, in favor of the "carried party." Hambrick, "Another Look at Some Old Problems—Percentage Depletion and the ABC Transaction," 34 *Geo. Wash. Law Review* 1, 31-32 (1965).

[11]According to the agreement, these properties consisted of (a) five mineral leaseholds of which Humble as lessee owned an undivided ½ interest and Cocke and Goodrich the other half as lessees; (b) three mineral leases in which Humble was sole lessee and Cocke and Goodrich were lessors; and (c) an "unleased mineral interest" underlying the area, jointly owned by Goodrich and Cocke. Thus it will be noted that each of Humble, Cocke, and Goodrich had at least part of the title to some of the leaseholds and interests comprising the Goodrich K properties. The parties made no attempt in the agreement to allot production according to title.

Goodrich and Cocke were designated non-Operators, and were each given a 25 per cent interest in production.

As Operator, Humble was obligated to advance all sums needed to conduct its operations and was entitled to recoup Operator's share of the advances from only one-half of the Non-Operators' 50 per cent share of production if any.[12]

Humble, then, had agreed to put up all of the money for drilling and production of the Goodrich K properties and to look only to one-half of the 50 per cent production interest of Goodrich and Cocke, Sr., for the proportionate share of the expenses to be borne by Goodrich and Cocke, Sr.

The second agreement concerns working interests in mineral leases and unleased mineral interests in Iberia Parish, Louisiana, known as the "Bayou Postillion" properties. These interests were owned by Humble, the California Company, Cocke, Sr., Cocke, Jr., and Goodrich.[13]

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[12]Paragraph 6 of the Agreement reads in part as follows:

> "Operator shall advance all monies necessary for conducting the operations hereunder and shall reimburse itself currently for Non-Operator's share of expenses and charges to the Joint Account out of one-half (½) of Non-Operator's proportionate interest in the current production."

[13]According to the agreement, these properties consisted of (a) 44 mineral leaseholds with Humble as lessee; (b) three mineral leases with California as lessee; (c) one mineral lease with California and Humble as lessees; (d) two mineral leases with Goodrich and Cocke as lessees; (e) one mineral lease with Goodrich alone as lessee; (f) one mineral lease with Nat V. Collier (otherwise unidentified) as lessee; and (g) certain "unleased mineral interests" held by Cocke, Sr., Cocke, Jr., R. H. Goodrich, and H. R. Goodrich under specified lands. Again each of the parties to this agreement had at least part of the title to some of the leaseholds and interests comprising the Bayou Postillion properties. Again the parties made no attempt in the agreement to allot production according to title.

To develop the Bayou Postillion properties these parties entered into an agreement among themselves on January 1, 1956. Humble was designated Operator and was given a 40.302 per cent interest in production. The California Company, a Non-Operator, was given a 48.06 per cent interest. Goodrich and the Cockes were given an 11.638 per cent interest among them. Humble and California were required to advance all the costs of drilling and development and could recoup the proportionate share of these outlays owned by Goodrich and the Cockes only from one-fourth of their proportionate interest of 11.638 per cent.[14]

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[14]Item II of the agreement reads in part:

> "Operator shall charge the Joint Account with all costs and expenses incurred in connection with the operation of the Joint Area as herein contemplated. . . . The charges made to the Joint Account as herein provided shall be borne by the parties hereto in the following manner:
>
> "1. Goodrich and [the] Cocke[s] shall bear all costs inconnection with the drilling of wells hereunder up to but not including the permanent tank batteries, in an amount equal to one-half of Goodrich and Cocke's proportionate interest. As to each well drilled hereunder, Humble and California shall advance Goodrich and Cocke's share of said costs, and shall be reimbursed only if such well be completed as a producer of oil, gas or other minerals, and then such reimbursement shall be only out of one-fourth of Goodrich and Cocke's proportionate interest. With respect to each well completed as a producer hereunder, all costs incurred in connection therewith subsequent to such completion, shall be borne by Goodrich and Cocke in an amount equal to the proportionate interest of Goodrich and Cocke in the Joint Area, provided, however, that Humble and California shall advance Goodrich and Cocke's share of all such costs, and shall be reimbursed only out of one-fourth of Goodrich and Cocke's proportionate interest in such well.
>
> "2. Humble and California shall each be responsible

In filing their respective tax returns for 1957 and 1958, taxpayers reported as income the sums which were used by Humble, under the two agreements, to pay taxpayers' share of the costs of drilling and development of the Goodrich K and Bayou Postillion properties. The taxpayers also claimed the following deductions: (1) percentage depletion based upon the proportionate share of proceeds of oil used by Humble to pay taxpayers' share of costs of drilling and development; (2) as expenses, similar proportionate shares of intangible drilling and development costs; (3) a similar proportionate share of depreciation of the amounts paid by Humble for tangible assets. Specifically, Cocke, Sr., and his wife reported the following income and deductions from the Goodrich K and Bayou Postillion properties for 1958:

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for its proportionate part of all cost incurred in connection with the drilling of wells hereunder, up to but not including the permanent tank batteries, and, in addition thereto, shall bear equally such cost in an amount equal to one-half of the proportionate interest of Goodrich and Cocke. As to costs incurred subsequent to completion of a well producing or capable of producing oil, gas or other minerals. Humble and California shall only bear such costs in proportion to their proportionate interest herein.

"Operator shall on behalf of the parties hereto initially pay and discharge all cost and expenses incurred in the development and operation of the Joint Area, and shall keep such area free and clear of all liens growing out of its operations hereunder, provided, however, that California shall, if requested by Humble, advance its part (determined in the manner immediately above set out) of the anticipated development and operating cost and expenses. . . ."

Item	*Goodrich K Properties*	*Bayou Postillion Properties*	*Total Reported*
Gross income	$13,986.18	$ 6,978.21	$20,964.39
Lease operating expenses	3,164.41	3,070.61	6,235.02
Production taxes	1,757.51	463.36	2,220.87
Depreciation	1,145.94	1,335.51	2,481.45
Depletion	3,846.20	1,722.12	5,568.32

Cocke, Jr., and his wife reported the following income and deductions from the Bayou Postillion properties for 1957:

Item	
Gross income	$ 3,916.49
Intangible development costs	17,829.37
Depreciation	581.61
Production taxes	336.12
Depletion	—0—

The Commissioner disallowed all income, depletion, operating expenses, and depreciation claimed by taxpayers as attributable to those sums which Humble used for recoupment of its outlays for costs of drilling and development, on the theory that this income and these several deductions were attributable to Humble, and that the only income and percentage depletion attributable to taxpayers was that from such of their interest as was not used by Humble to recoup its costs and expenses.[15]

[15]The income and expenses claimed by Cockes but disallowed by the Commissioner were claimed by Humble on its return, and as such were allowed by the Commissioner.

The Commissioner determined that only the following income and expenses should have been reported on the return of Cocke, Sr., for 1958:

Item	*Goodrich K Properties*	*Bayou Postillion Properties*	*Total*
Gross income	$ 7,871.89	$ 5,233.66	$13,105.55
Lease operating expenses	—0—	—0—	—0—
Production taxes	989.75	347.52	1,337.27
Depreciation	—0—	—0—	—0—
Depletion	2,164.77	1,439.27	3,604.04

The Commissioner further determined that only the following income and expenses should have been reported on the return of Cocke, Jr., for 1957:

Item	
Gross Income	$ 3,916.49
Intangible development costs	—0—
Depreciation	—0—
Production taxes	336.12
Depletion	1,077.03

Based upon his computations the Commissioner assessed additional taxes and interest for the returns in question. Taxpayers paid the assessments and filed suit for refund in district court. The government's announced defense to this refund suit was that the case of *Commissioner v. J. S. Abercrombie Co., supra,* was no longer valid. The district court, relying on *Abercrombie,* gave judgment for the taxpayers. *W. H. Cocke v. United States,* S.D. Tex. 1966, 263 F. Supp. 762.

A comparison of the facts in *Abercrombie* and of the present case shows that, essentially, the present case presents again the precise issues of *Abercrombie,* with one exception, which we deem without substance.[16] In both cases the carrying parties agreed to finance the drilling and development costs by themselves, and to look only to production for recoupment of these costs. In both cases, the carried parties were not personally liable for the drilling costs, but agreed to allow the carrying parties to recoup all of the drilling and development costs before receiving their full share of payments (in money or oil) out of production. In other words, in each case the carrying party agreed to bear all of the risk of drilling and development, and the carrying party agreed to subordinate its interest in production to the repayment of the carrying party's outlays. In neither case did the carried party assign its entire portion of the working interest (as in *Manahan* transactions) or an oil production payment (as in *Herndon* transactions) to the carrying party for the duration of the recoupment period.

III.

We have concluded that our own cases, both earlier and later than *Abercrombie,* cases of other courts on the same or related subjects, and the sound policy of taxing according to the substance of a transaction rather than

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[16]In *Abercrombie,* the carried party originally held the entire working interest, granted a portion of it to the carrying party in return for the obligation to drill, etc. Here, the carried and carrying parties were existing co-owners of the working interest when the carrying party took on his obligations. The distinction is without significance. Breeding and Burton, *Income Taxation of Oil and Gas Production* ¶2.08 at p. 207 (1961); Ryan, "The Carried Interest in the Fifth Circuit, or, Is *Abercrombie* Dead," 4 *Houston Law Review* 477, n. 1 (1966).

its form, all instruct us to disapprove of *Abercrombie* and of the taxpayer's position here.

"The principle of looking through form to substance is no schoolboy's rule; it is the cornerstone of sound taxation, especially of oil and gas transactions which do not fit snugly into common law conveyancing forms." *Weinert's Estate v. Commissioner, supra,* 294 F.2d at 755. Common law property concepts may aid in identifying certain interests, but they are not crystallizations of an absolute truth. Pedantic adherence to medieval enfeoffments—which are relics of an age of surface use of lands and are alien to vertical and subterranean ownerships—is worthless and indeed harmful. It requires the same fictionalizing and logic-chopping which became notorious during the attempts to fit new causes of action into the old forms of action. Success in such endeavors is as fugacious as the oil and gas in question.

The Supreme Court realized, as early as 1925, that the right to depletion deductions was not limited to those who had "title" in the deposits.

> "It is said that the depletion allowance applies to the physical exhaustion of the ore deposits, and since the title thereto is in the lessor, he alone is entitled to make the deduction. But the fallacy in the syllogism is plain. The deduction for depletion in the case of mines is a special application of the general rule of the statute allowing a deduction for exhaustion of property. While respondent does not own the ore deposits, its right to mine and remove the ore and reduce it to possession and ownership is property within the meaning of the general provision. Obviously, as the process goes on, this property interest of the lessee in the mines is lessened from year to year, as the owner's property interest in the same mines

> is likewise lessened. There is an exhaustion of property in the one case as in the other. *Lynch v. Alworth-Stephens Co.*, 1925, 267 U.S. 364, 370, 45 S.Ct. 274, 69 L.Ed. 660.

In *Burnet v. Harmel*, 1932, 287 U.S. 103, 53 S.Ct. 74, 77 L.Ed. 199, the Court again ruled that the "economic consequences," rather than the conclusory characterizations of local land law, govern the taxation of a bonus paid for a mineral lease.

Palmer v. Bender, 1933, 287 U.S. 551, 555-56, 53 S.Ct. 225, 226, 77 L.Ed. 489, 492, is recognized today as having swept away distinctions based upon "formal attributes of [the legal instruments in question] or the descriptive terminology which may be applied to them in the local law" in determining who has a depletable interest in minerals. The Court instated the "economic interest" principle instead. We repeat what we first quoted in *Weinert's Estate*, 294 F.2d at 755: "[T]he office of the economic interest [is] to identify the party to whom benefits and burdens attendent to mineral production are to be attributed for tax purposes." See also Branscomb, "Recent Developments in Oil and Gas Taxation," *11th Annual Oil and Gas Institute of the Southwest Legal Foundation* 615, 617 (1959).

In two pre-*Abercrombie* cases, this Court followed the realistic concept. In *Ortiz Oil Co. v. Commissioner*, 5 Cir. 1939, 102 F.2d 508, Ortiz wished to exercise options which it held to acquire and develop certain oil property. Westbrook and Thompson agreed to furnish Ortiz sufficient money to buy the property and to drill, in return for the promise by Ortiz to repay Westbrook and Thompson, with high interest, out of proceeds from production of the wells to be drilled on the land in question. Ortiz claimed

that the transaction was a loan, and that the funds repaid were income to it, with deductions for depletion and interest. We held that the transaction was a sale of oil in place and that the money furnished by Westbrook and Thompson was not a loan.

> "It was a cash consideration for a conveyance of stipulated proportions of oil production to the extent in value of $359,333.34 if, as, and when the oil was produced. The portions of production specified belonged to and constituted property of Westbrook and Thompson and the petitioner was only obligated to pay over and account to them when and if the oil was produced. If no oil was produced Westbrook and Thompson got nothing and Ortiz Oil Company was under no obligation to pay them anything. The undertaking was in no sense a joint venture. Petitioner was to manage, develop, and operate the properties and pay all expenses. The contract is clear in this regard.
>
> "Westbrook and Thompson were entitled under the contract to receive specified proportions of the proceeds of oil sales or to take their actual share of the oil production. They simply acquired an interest in oil in place. The right to share in the oil produced constitued an economic interest in the properties to the extent of the amount agreed upon. Palmer v. Bender, 287 U.S. 551, 53 S.Ct. 225, 77 L.Ed. 489."

102 F.2d at 509. We emphasized in *Ortiz* that Westbrook and Thompson had agreed to look only to the possible production, and that Ortiz was not "personally" liable on the obligation. A similar line of reasoning was advanced in the second case, *Commissioner v. Caldwell Oil Corp.*, 5 Cir. 1944, 141 F.2d 559.

In *Wood v. Commissioner*, 5 Cir. 1960, 274 F.2d 268, we had before us what the dissent in that case called "a

typical *Abercrombie* situation." There the taxpayer was a Texas divorcee who had been awarded in the divorce decree one-half of the community's 45 per cent interest in certain oil and gas production, the interest becoming payable to her after the payment of certain community debts. The taxpayer was not personally liable for the debts, and proceeds of production had been assigned to pay them. The Commissioner contended that the payment of these debts was a benefit to the taxpayer and therefore income to her. We rejected this contention, emphasizing the state court's characterization of the taxpayer's interest as a reversionary interest without "title" until the debts were paid. The Court's refuge from *Abercrombie* was a finding of no title, but the dissent showed this to be a vulnerable sanctuary.

The facts of *Weinert's Estate v. Commissioner*, 1961, 294 F.2d 750, did not require the overruling of *Abercrombie*, but in our discussion of the legal issues we noted that *Abercrombie* need be narrowly read in order not to conflict with *Weinert*. Weinert owned a working interest in certain oil and gas properties. He agreed to sell to Lehman one-half of this interest, plus a $50,000 production payment out of the proceeds of his retained half. Lehman agreed, in return, to pay Weinert $100,000 cash, and to drill and develop the oil property. In addition, Lehman agreed to "loan and advance" up to $150,000 to pay Weinert's "share" of the drilling and development costs. However, Weinert was not personally liable on this obligation. Repayment, indeed, was accomplished in the following fashion: Weinert assigned his retained half of the working interest to a trustee. The trustee was instructed to pay to Lehman any excess of proceeds from production over Weinert's share of operating costs. These payments to Lehman were to liquidate the $150,000 obligation

(plus two per cent interest) and then the $50,000 production payment. When these had been paid, the trustee and Lehman were to reassign the interest to Weinert. The Commissioner claimed that sums paid to liquidate the $150,000 "indebtedness" were income to Weinert. We held otherwise, and the principles expounded in *Weinert* (including references to our earlier cases above stated) plus related Supreme Court cases will, in Section IV of this opinion, be used to dispose of the issues of the present case. Our chronological survey concludes with the Ninth Circuit's decisive attack on the very foundation of the *Abercrombie* doctrine.

In *United States v. Thomas*, 9 Cir. 1964, 329 F.2d 119, the taxpayers, operating under the name Quality Oil Company, entered into an operating agreement with Richfield Oil Company. Under the agreement Quality held title to an undivided interest in certain leases, but Richfield was granted the sole right to drill, develop, and operate the property. Richfield's burden of operation and Quality's obligation of reimbursement closely resembled the agreement at bar, and in fact the Thomases claimed to have an *Abercrombie* "carried interest." We quote from the *Thomas* opinion:

> "Appellees contend they have a 'carried interest' in the oil and gas in place.
>
> "In support of such contention appellees rely on the following cases: Reynolds v. McMurray, 60 F.2d 843 (10th Cir. 1932) C.D. 287 U.S. 664, 53 S.Ct. 222, 77 L.Ed. 573; Helvering v. Armstrong, 69 F.2d 370 (9th Cir. 1934); T. K. Harris Company v. Commissioner, 112 F.2d 76 (6th Cir. 1940); Commissioner v. J. S. Abercrombie, 162 F.2d 338 (5th Cir. 1947); Prater v. C.I.R., 273 F.2d 124 (5th Cir. 1959).

"While the legal relationship between Richfield and Quality, viewed from the standpoint of property law concepts is, in form, that of co-owners of the working interest in the leases involved, the Supreme Court in the cases above cited has made it clear that legal title and property law concepts alone are not determinative of the party who has an economic interest in the working interest. In the area of taxation economic realities determine tax consequences. . . .

"In our view the substance and effect of the legal arrangement between Richfield and Quality is that Quality assigned to Richfield, at the beginning of the legal relationship, so much of Quality's oil and gas in place as would be needed during the term of that relationship to reimburse Richfield for Quality's portion of the development and operating expenses, and thus retained not an economic interest in the working interests of the leases but in reality only a 'net profits' interest. The fact that the proceeds from production in the years in question exceeded the cost of development and operation expenses incurred during those years does not alter the fact that Richfield bore the risk and burden of Quality's share of the expenditures and looked solely to production for recoupment.

"We concede that the holdings in the cases relied upon by appellees support their contentions.

"The holdings in McMurray, Armstrong and Harris are based primarily, if not wholly, upon property law concepts, and the opinions in those cases give no consideration to the 'economic interest' concept as developed in many of the Supreme Court cases above cited. Likewise Abercrombie and Prater rely upon property law concepts and resort to legal fictions which were severely criticized by a recent decision of the same Circuit [citing the *Weinert* case in a footnote], and their precedential value was largely undetermined.

> "We are in no position to overrule any of the cases relied upon by appellees except the Armstrong case. We believe that the vitality of that case has been sapped by the above cited decisions of the Supreme Court and we expressly overrule the decision in Armstrong." 329 F.2d at 130-31.

The taxpayers at bar point to a distinguishing factor in the *Thomas* case in that the Thomasses obtained no interest in any of the equipment or improvements. The distinction is without substance in light of the Ninth Circuit's clear pronouncements of law, its specific overruling of a prior case of theirs upon which we had relied in *Abercrombie* for support, and its critical comments on *Abercrombie* itself.

IV.

A. Title is not controlling. We said in *Weinert:*

> "The difficulty in applying Abercrombie to sharing arrangements generally is that, however correct the decision may have been on the facts before the Court, the statements in the opinion emphasizing the common law concept of ownership tend to weaken the tax concept of economic interest, so important in oil and gas taxation—to the Government as well as to taxpayers. If Abercrombie is interpreted too broadly, it will discourage sharing arrangements created out of the exigencies of the oil and gas business and necessary, in many cases, to development of oil and gas property. 294 F.2d at 756."

We add Professor Hambrick's assessment of *Abercrombie* for our *coup de grace:*

> "Whatever uncertainties may remain in the wake of the Supreme Court's landmark decisions on depletion,

> they do not include the proposition that the ownership of a legal interest in oil and gas or other mineral in place determines the income share of the owner or his allowance for depletion, where by contract or otherwise the economic value has been transferred to another. Hambrick, "Another Look at Some Old Problems—Percentage Depletion and the ABC Transaction," 34 *Geo. Wash. Law Review* 1, 32 (1965).

This conclusion is correct; virtually every Supreme Court case touching on the issue has eschewed title as a deciding factor. *Lynch v. Alworth-Stephens, supra, Burnet v. Harmel, supra, Palmer v. Bender, supra, Thomas v. Perkins,* 1937 301 U.S. 655, 57 S.Ct. 911, 81 L.Ed. 1324; *Kirby Petroleum Co. v. Commissioner,* 1946, 326 U.S. 599, 66 S.Ct. 409, 90 L.Ed. 343; *Burton-Sutton Oil Co. v. Commissioner,* 1946, 350 U.S. 308, 76 S.Ct. 395, 10 L.Ed. 347. The reason for this position is clear. "Title" is a collocation of rights. It is a legal conclusion. The several rights which make up title vary from state to state, and are not always relevant to tax litigation. The owner of title may divest himself of title without losing any rights, such as by placing title in a trustee as was done in *Weinert.* Title is relevant in tax litigation only insofar as significant benefits or burdens accompany it. It is easier, less dangerous, and more nearly accurate to speak of these relevant benefits and burdens individually than it is to lump them uncertainly together and deal with them as "title." Cf. Justice Holmes' famous remark in *Corliss v. Bowers,* 1930, 281 U.S. 376, 378, 50 S.Ct. 336, 74 L.Ed. 916, 917: "[T]axation is not so much concerned with the refinements of title as it is with actual command over the property taxed — the actual benefit for which the tax is paid." Cf. also *Helvering v.*

Horst, 1940, 311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75; *Helvering v. Clifford*, 1940, 309 U.S. 331, 60 S.Ct. 554, 84 L.Ed. 788.

In the present case the relevant issue is whether the carrying party had "an economic interest in . . . the oil. . . . By this is meant only that under his contract he must look to the oil in place as the source of the return of his capital investment. The technical title to the oil in place is not important." *Kirby Petroleum Co. v. Commissioner, supra*, 326 U.S. at 603, 66 S.Ct. at ____, 90 L.Ed at 348. Sneed, "The Economic Interest — An Expanding Concept," 35 *Texas Law Review* 307 (1957).

We reject the notion that title controls, and we pass to the real issue here.

B. We hold that taxpayers here had no economic interest in the oil which produced the income questioned here.

> "Under Palmer v. Bender two elements constitute the requirement of an economic interest. First, the taxpayer must have acquired by investment an interest to the minerals in place. Second, 'he must look for a return of his capital' to the 'income derived from the extraction of the oil' — by 'any form of legal relationship.'
>
> "The issue is an economic one. The stake in the minerals is what counts: the income from oil and gas is taxable to the man who risks his stake to produce oil and gas. *Weinert's Estate*, 294 F.2d at 756."

We held in Weinert that the agreement to "loan and advance" the $150,000 for Weinert's share of drilling

and development costs was in fact not a loan, but a sharing arrangement. We emphasized, citing *Ortiz v. Commissioner, supra,* that the carried party was not risking anything and was not liable for repayment if the wells did not produce. The same substance is true here. Humble did not look to the Cockes for repayment of the outlays; it looked only to the oil which its outlays might or might not produce. Its stake was in the minerals in the ground and not in the credit rating of the taxpayers here. Its risk was economic, and its interest was an economic interest.

> "This opportunity of converting a right to develop the possibility of oil into property is the only ownership of minerals that has tax significance; bare ownership in place of minerals 12,000 feet underground, or perhaps not there at all, or if there perhaps not exploitable, has little if any real meaning—or should have little meaning for income tax purposes. It is the development of this opportunity into producing wells having a present economic usefulness that results in income values. That is the teaching of Palmer v. Bender." *Weinert's Estate,* 294 F.2d at 762.

We think that the present direction of *Palmer v. Bender* is illustrated by *Commissioner v. Southwest Exploration Co.,* 1956, 350 U.S. 308, 76 S.Ct. 395, 100 L.Ed. 347. There, the taxpayer had contracted to develop certain oil deposits lying off the coast of California. However, California law prohibited the drilling of such wells except on filled land (at the time unavailable) or by slant-drilling from upland sites. Taxpayer therefore contracted with an owner of uplands, agreeing to pay such owner 24-1/2 per cent of net profits. The taxpayer

sought to claim the depletion allowance on the upland owner's share of the profits. The Supreme Court, citing the economic interest test in *Palmer v. Bender, supra,* held that because the upland owner had made an essential contribution to production by providing the only site possible for drilling, the upland owner had gained an economic interest in the oil in place and was entitled to the depletion allowance.

V.

Though both the government and the Cockes urge upon us the sodality of a unified triumvirate of depletion, depreciation, and intangible drilling and development costs, we have quested for any difference among them which would yield different results in this case. We now conclude, however, that depreciation and intangible drilling and development costs are subservient satellites of depletion in situations involving carried interests, and that, as the spoils go to the victor, so these deductions go to the rightful depleter.

It is rather elementary taxation that the statutory right to depreciation does not necessarily follow legal title. *Helvering v. Lazarus & Co.,* 1939, 308 U.S. 252, 60 S.Ct. 209, 84 L.Ed. 226. See also *Armston Co. v. Commissioner,* 5 Cir. 1951, 188 F.2d 531, 533-34; *Commissioner v. Moore,* 9 Cir. 1953, 207 F.2d 265, 268-69, cert. den., 1954, 347 U.S. 92, 74 S.Ct. 637, 98 L.Ed. 1091; *First National Bank of Kansas City v. Nee,* 8 Cir. 1951, 190 F.2d 61, 68. To take depreciation a taxpayer must also have an investment or basis in the equipment. *Detroit Edison Co. v. Commissioner,* 1943, 319 U.S. 98, 63 S.Ct. 902, 87 L.Ed. 1286; *United States v. Georgia Railroad*

and Banking Co., 5 Cir. 1965, 348 F.2d 278, 288 (fn. 25 and accompanying text), cert. den., 1966, 382 U.S. 973, 86 S.Ct. 538, 15 L.Ed.2d 465; 4 Mertens, *Federal Income Taxation* §§ 23.19 and 23.21.

A carried party, however, spends none of his funds for equipment. His only claim to basis is through the fictional "loan" whose substance fades with the passing of *Abercrombie*. As Judge Wisdom observed in his dissenting opinion in *Prater v. Commissioner*, 5 Cir. 1959, 273 F.2d at 126-27:

> "Putting aside fictions, the plain fact is that there is no loan or pledge or charge equivalent to payment in cash—when the taxpayer has no firm obligation to repay the carrier's advances (should there be insufficient production) and the carried interest has no value (if there should be no production)."

In essence the Cocke and Humble relationship is indistinguishable from that found in *United States v. Thomas*, 9 Cir. 1964, 329 F.2d 119, discussed in Section IV, *supra*. The Cockes made no payment for, and thus had no investment in, the depreciable property. Therefore, while unlike the Thomases, they possessed legal title to the depreciable property, like the Thomases, they could not claim any depreciable interest. Putting it another way, their interest in that property, for tax purposes, had a basis of zero.

Our discussion of intangible drilling and development costs will begin with another general tax principle, that deductions for expenses can be taken only by the party who actually "paid or incurred" them. See 26 U.S.C.

§ 162;[17] 26 U.S.C. § 212;[18] *Helvering v. Price,* 1940, 309 U.S. 409, 413, 60 S.Ct. 673, 675, 85 L.Ed. 836, 839; *Eckert v. Burnet,* 1931, 283 U.S. 140, 51 S.Ct. 373, 75 L.Ed. 911. "There are no provisions in the tax laws whereby one taxpayer can deduct from his gross income expenses incurred and defrayed by another." *H. W. Nelson Co. v. United States,* Ct. Cl. 1962, 308 F.2d 950, 954. The focal word "incurred" is likewise present in the Treasury Regulation concerning intangible drilling and development costs:

> "1.612-4(a). Option with respect to intangible drilling and development costs. In accordance with the provisions of section 263(c) [see Appendix, *infra*], intangible drilling and development costs *incurred* by an operator . . . in the development of oil and gas lease properties may at his option be chargeable to capital or to expense." (Emphasis added).

"Incur" has substantiality and strong kinetics and does not embrace a contingent charge on a hoped-for asset over which the taxpayer has no present authority or control. See *United States v. St. Paul Mercury Indemnity Co.,* 8 Cir., 1956, 238 F.2d 594, 598 (and authority cited therein); *American Hotels Corp. v. Commissioner,* 2 Cir. 1943, 134 F.2d 817, 819. At the time that moneys were expended by Humble for intangible drilling and develop-

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[17] § 162. *Trade or business expenses*

(a) In general. — There shall be allowed as a deduction all the ordinary and necessary expenses *paid or incurred* during the taxable year in carrying on any trade or business, including. . . ." (Emphasis added.)

[18] § 212. *Expenses for production of income.*

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses *paid or incurred* during the taxable year. . . ." (Emphasis added.)

ment costs, the Cockes were financially passive, not to be heard unless and until Humble's operation was successful. Moreover, during the reimbursement period tax consequences for all money received by Humble were, as we have held, attributable to Humble. Intangible drilling and development costs prove no exception to our now-consistent rule that the carried interest arrangement "reallocates, temporarily, the benefits and burdens of developing and operating an oil lease. . . ." *Weinert's Estate v. Commissioner,* 5 Cir. 1961, 294 F.2d 750, 757. See also Bennion, "Intangible Drilling and Development Costs: The Final Regulations," *Fifteenth Annual Tulane Tax Institute* 665 (1966).

VI.

The passing of *Abercrombie* into historical desuetude is not without its jurisprudential complications. Thus, it has been suggested, first, that to overrule *Abercrombie* would violate the canons of stare decisis and, second, that if we must overrule *Abercrombie,* we should do so prospectively in order to relieve the abrasive overtones of a change in law. We pause to consider both suggestions.

Our law is neither moribund nor muscle-bound. There are justifiable escapes and liberations from the rigidities and inflexibilities of stare decisis.[19] We repair to the wisdom of Cardozo when he wrote:

> "Through one agency or another, either by statute or by decision, rules, however well established, must be revised when they are found after fair trial to

[19]We note with interest that on July 26, 1966, the House of Lords proclaimed that in the future it would "no longer regard itself as absolutely bound by its own precedent decisions." 82 *Law Quarterly Review* 441 (October, 1966).

be inconsistent in their workings with an attainment of the ends which law is meant to serve. The revision is a delicate task, not to be undertaken by gross or adventurous hands, lest certainty and order be unduly sacrificed, yet a task also not to be shirked through timidity or sloth." Cardozo, *The Growth of the Law* 120 (1924).

Moreover, our reapprisal of carried interest taxation need have no agonizing overtones because it has been presaged.[20] In this respect our present position is remark-

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[20] *United States v. Thomas*, 9 Cir. 1964, 329 F.2d 119; *Weinert's Estate v. Commissioner*, 5 Cir. 1961, 294 F.2d 750. See also Ryan, "The Carried Interest in the Fifth Circuit, or, is *Abercrombie* Dead?", 4 *Houston L. Rev.* 477 (1966); Bennion, "Intangible Drilling and Development Costs: The Final Regulations," *Fifteenth Annual Tulane Tax Institute* 665, 676-82 (1966); Hambrick, "Another Look at Some Old Problems—Percentage Depletion and the ABC Transaction," 34 *Geo. Wash. L. Rev.* 1, 31-32 (1965); Caplan, "Taxation of Carried Interests: A Study in Gossamer Distinctions," 7 *So. Texas L. J.* 239 (1964); Appleman, "Oil and Gas Tax Law — 1964 Critique," *Southwestern Legal Foundation Fifteenth Annual Institute on Oil and Gas Law and Taxation* 457, 469-74 (1964); "The Trend in Carried Interest Cases," 17 SW. L. J. 242 (1963); Shoenbaum, "Significant Federal Tax Developments Affecting Oil and Gas," *Southwestern Legal Foundation Thirteenth Annual Institute on Oil and Gas Law and Taxation* 481-86 (1962); Bean, "Taxation of Carried Interests in Oil and Gas Transactions — In Retrospect and Prospect," 10 *Kansas L. Rev.* 391 (1962); Note, 22 *La. L. Rev.* 685 (1962); 12 *Oil and Gas Tax Q.* 41 (1962); 11 *Oil and Gas Tax Q.* 233 (1962); 11 *Oil and Gas Tax Q.* 81 (1962); Hambrick, "A New Look at the Carried Interest," *Tenth Annual Tulane Tax Institute* 304 (1961); 10 *Oil and Gas Tax Q.* 108 (1961); Galvin, "The 'Ought' and 'Is' of Oil-and-Gas Taxation," 73 *Harvard L. Rev.* 1441, 1492-94 (1960); Branscomb, "Recent Developments in Oil and Gas Taxation," *Southwestern Legal Foundation Eleventh Annual Institute on Oil and Gas Law and Taxation* 615, 633-41 (1960); 9 *Oil and Gas Tax Q.* 222 (1960); Peck, "Recent Developments in Oil and Gas Taxation," *Southwestern Legal Foundation Tenth Annual Institute on Oil and Gas Law and Taxation* 421, 458-61 (1959); 8 *Oil and Gas Tax Q.* 238 (1959); Bullion "A New Look at Tax Aspects of Oil

ably similar to that of the Second Circuit in *Chappell & Co. v. Frankel*, 2 Cir. 1966, 367 F.2d 197 (concerning the rule on appealability of an order denying summary judgment). Sitting en banc and speaking through Judge Waterman, that Court said:

> "We recognize that though we are privileged in accord with the genius of the common law to decide cases on a case-by-case basis it 'does not relieve us of the judicial obligation to pay proper heed to precedent: the question still is not what we would hold if we now took a fresh look but whether we should take that fresh look'. . . . On the other hand the doctrine of *stare decisis* has never been thought to limit a court's power to 'take a fresh look' in appropriate instances. . . . [T]he rule of our circuit has commanded no following in other federal courts of appeals and has been much criticized by the commentators. This unfavorable reaction to our earlier decisions has led us to the '* * * strong * * * view that the challenged precedent is probably wrong * * *.'" 367 F.2d at 200-201.

We now essay the question of prospection versus retroaction. The Cockes, who view the impending demise of *Abercrombie* with understandable exacerbation, beseech us to immunize them from any change by making our

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and Gas Sharing Arrangements," *Southwestern Legal Foundation Eighth Annual Institute on Oil and Gas Law and Taxation* 603 (1957); Winstead, "Carried Interests and Net Profits Interests," *Southwestern Legal Foundation Second Annual Institute on Oil and Gas Law and Taxation* 517 (1951); See also Breeding and Burton, *Income Taxation of Oil and Gas Production* §§ 2.08, 8.15 (1961 ed.); Paulston, "Tax Consequences of 'Net Interests' in Oil and Gas Transactions," *P-H Oil and Gas Taxes* ¶ 1009, 1009.8; Branscomb, "Allocating Income in Carried Interests," *P-H Oil and Gas Taxes* ¶ 2023. Additional authority is cited in *Weinert's Estate, supra*, 294 F.2d at 755-56 (fn. 11).

decision purely prospective.[21] Moreover, the long history of judicial and Internal Revenue Service ambivalence in this area gives some validity to their plea. Judicial inclination toward title-loan concepts began in three carried interest cases well before *Abercrombie*. *Reynolds v. McMurray*, 10 Cir. 1932, 60 F.2d 843, cert. den., 287 U.S. 664, 53 S.Ct. 222, 77 L.Ed. 573; *Helvering v. Armstrong*, 9 Cir. 1934, 69 F.2d 370; *T. K. Harris Co. v. Commissioner*, 6 Cir. 1940, 112 F.2d 76. In 1941, however, the Service (then the "Bureau of Internal Revenue") published its opus ruling on mineral taxation, General Counsel's Memorandum (G.C.M.) 22730, and expressed disagreement with the principles of the *Reynolds v. McMurray* decision, *supra*. Adopting the view that a carried interest is similar to a net profits interest, the Service concluded that the owner of a carried interest is not taxed upon income therefrom until such income is received.[22] The Tax Court's opinion in *Abercrombie*, which was filed on June 12, 1946, was inconsistent with G.M.C. 22730, and shortly thereafter the Service filed a non-acquiescence. 1946-2 Cum. Bull. 6. But in 1949, two years after our Court had affirmed the Tax Court in *Abercrombie*, the Service withdrew its non-acquiescence. 1949-1 Cum. Bull. 1. During the same year a district court in our Circuit followed *Abercrombie* and held for the taxpayer. *Foster v. United States*, S.D. Tex. 1949, 85 F. Supp. 447. No appeal was taken by the government.

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[21]"A ruling which is purely prospective does not apply even to the parties before the court." *Linkletter v. Walker*, 1965, 381 U.S. 618, 622, 88 S.Ct. 1731, 14 L.Ed.2d 601.

[22]G.C.M. 22730, 1941-1 Cum. Bull. 214, 223-24. "The policy adopted in GCM 22730, 1941-1 Cum. Bull. 214 and GCM 24849, 1946-1 Cum. Bull. 66 embodies the Manahan-Herndon approach." *Weinert's Estate, supra*, 294 F.2d at 757 (fn. 14).

It was in light of the above judicial and administrative decisions that the Cockes, in 1955 and 1956, executed the contracts involved in this case. Three years later the carried interest controversy arose again when the Service attempted to restrict *Abercrombie* and to exclude the application of title-loan concepts in deductions for operating losses. The attempt failed. *Prater v. Commissioner*, 5 Cir. 1959, 273 F.2d 124.

On April 29, 1960, the Service published notice of the adoption of tax regulations, one of which would have completely abrogated the *Abercrombie* rule. 25 *Federal Register* 3761 (1960). When these regulations were finally promulgated in 1965, T.D. 6836, 1965-2 Cum. Bull. 182, the anti-*Abercrombie* regulation had been eliminated. Moreover, in 1961 the Service itself even relied on *Abercrombie* in the case of *Weinert's Estate*. We quote from the opinion in that case:

> "Before this Court the Commissioner relies: (1) on Abercrombie and Prater to show that the carrying party's advances were a loan; . . ." 294 F.2d at 752.

In 1963 "the Service returned to the path of righteousness, never more to roam, we hope,"[23] and reinstated its 1946 non-acquiescence with *Abercrombie*. 1963-2 Cum. Bull. 6 (see specifically fn. 18 at p. 7). Finally, in 1964 the Ninth Circuit decided the *Thomas* case, which we have discussed in prior sections of this opinion.

As has been shown, consistency in regard to *Abercrombie* has not been the guiding star of the Service or

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[23]Hambrick, "Another Look At Some Old Problems — Percentage Depletion and the ABC Transaction," 34 *Geo. Wash. L. Rev.* 1, 31 (fn. 115) (1965).

of the courts. Stressing this inconsistency, the Cockes argue that we should not apply our present ruling to their contract because such contract had been executed during a period of calm, marked by approvals of *Abercrombie* by both our Court and the Service. Our rejection of this estoppel line of argument is due to both a disinclination to accept the factual premise and a demurrer as to the law of prospectivity.

The Service maintains that, despite its 1949 formal acquiescence, it has never embraced the *Abercrombie* doctrine and has, in fact, worked consistently toward an erosion of that doctrine. Most commentators agree. In 1961 Judge Wisdom commented in *Weinert's Estate*, supra, 294 F.2d at 756-57:

> "We interpret Abercrombie narrowly, as indeed, the Service—prior to the instant case—has consistently interpreted it."

A footnote to the above comment contains both a history of Service reaction to *Abercrombie* and three excerpts from leading commentators. We will repeat only the last:

> "After the affirmance by the Court of Appeals the Commissioner's non-acquiescence in the Tax Court's decision was withdrawn. However, in spite of the withdrawal the Service's policy is to restrict the application of *Abercrombie* narrowly to cases involving similar facts. Indeed, from all indications, it would not be surprising if the Service were to refuse to apply the *Abercrombie* principle to an exactly similar factual situation unless the taxpayer's name were also J. S. Abercrombie Co. Peck, "Recent Developments in Oil and Gas Taxation," *Southwest-*

ern Legal Foundation Tenth Annual Institute on Oil and Gas Law Taxation 421, 459 (1959).[24]

A subsurface view of the supposed calm, then, convinces us that the Service, though formally quiescent, had let it be known that *Abercrombie* was not in favor. We must assume that the Cockes, if they knew about and were concerned with the *Abercrombie* doctrine, also knew the likelihood of further Service attacks upon that doctrine.

Under Section 7805(b) of the Code the Service can enforce the withdrawal of an acquiescence either retro-

[24]Judge Wisdom also maintained in *Weinert's Estate* that the application of "economic realities" in taxation of oil and gas "is in harmony with the administrative position on the allocation of income and deductions in sharing arrangements, a position that since the publication of GCM 22730, 1941-1 Cum. Bull. 214, has been relatively stable." 294 F.2d at 752. One commentator has been even more emphatic: "It is to the great credit of the Service that it has with a considerable degree of consistency sought the demise of the *Abercrombie* principle ever since the publication of its well-reasoned ruling in G.C.M. 22730, 1941-1 C.B. 214, 223-224." Bennion, "Intangible Drilling and Development Costs: The Final Regulations," *Fifteenth Annual Tulane Tax Institute* 665, 682 (1966). Finally, we note Professor Hambrick's amusing account of the Service's frustrations and its pragmatic approach: "The Internal Revenue Service was given a bad time by the *Abercrombie* decision. It was in conflict with the Service's masterwork on depletion and the division of income from the exploitation of natural resources deposits. G.C.M. 22730, 1941-1 Cum. Bull. 214. At the same time G.C.M. 22730 was out of step with the decisions in *Kirby Petroleum* and *Burton-Sutton* on the status of a net profits interest. At first the Service noted its formal disagreement with Abercrombie, nonacq., 1946-2 Cum. Bull. 6. Later, apparently in order to put itself in a "compromising" position (to settle other similar cases in the same circuit) and still remain an 'honest woman,' the Service entered on the record its acquiescence, 1949-1 Cum. Bull. 1. Finally, the Service returned to the path of righteousness, never more to roam, we hope, nonacq., 1963-1 Cum. Bull. 5." Hambrick, *supra*, note 23.

actively or prospectively,[25] and it is now clear that the Service has broad discretion as to the application of Section 7805(b). *Dixon v. United States*, 1965, 381 U.S. 68, 85 S.Ct. 1301, 14 L.Ed.2d 223; *Automobile Club of Michigan v. Commissioner*, 1957, 353 U.S. 180, 77 S.Ct. 707, 1 L.Ed.2d 746. We quote from the Court in *Dixon, supra*, 381 U.S. at 79-80:

> "Insofar as petitioners' arguments question the policy of empowering the Commissioner to correct mistakes of law retroactively when a taxpayer acts to his detriment in reliance upon the Commissioner's acquiescence in an erroneous Tax Court decision, their arguments are more appropriately addressed to Congress. Congress has seen fit to allow the Commissioner to correct mistakes of law, and in § 7805 (b) has given him a large measure of discretion in determining when to apply his corrections retroactively. In the circumstances of this case we cannot say that this discretion was abused."

To be sure, courts can enforce prospectivity upon a Service ruling in order to prevent discrimination or substantial injustice. See *International Business Machines Corp. v. United States*, Ct.Cl. 1965, 343 F.2d 914, cert. den., 1966, U.S. 1028, 86 S.Ct. 647, 15 L.Ed.2d 540, wherein the Service had attempted to charge retroactively an excise tax against I. B. M. machinery during the same years that it had exempted, by prospective ruling, I. B. M.'s sole competitor in the particular industry, Remington Rand.

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[25] 26 U.S.C. § 7805(b):

> *"Retroactivity of Regulations or Rulings.* — The Secretary [of the Treasury] or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect."

But see *Bookwalter v. Brecklein,* 8 Cir. 1966, 357 F.2d 78, which distinguishes and limits the *I. B. M.* case. See generally 2 Davis, *Administrative Law* §§ 17.01-17.09 (Chapter 17: "Estoppel and Stare Decisis") (1958). As to Service discretion, however, the facts in *Dixon* bear close resemblance to the facts at bar.

Turning finally to judicial prospectivity, we reserve for a more propitious and compelling case a decision on the constitutional inhibition against prospective effectuation of an opinion.[26] "Pure prospectivity," even if constitutionally

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[26]The government submits that as a consequence of Article III, Section 2 of the United States Constitution, which limits the judicial power of the federal courts to adjudicating "cases" or "controversies," a federal court is without jurisdiction to overrule a prior decision and to announce a new rule of law that does not govern the decision of the case before it. At least one commentator agrees (although more on policy grounds than on strict adherence to constitutional principles). Note, "Prospective Overruling and Retroactive Application in the Federal Courts," 71 *Yale L. J.* 907, 930-33 (1962). Moreover, in the latest Supreme Court pronouncement on point that Court indicated a willingness to accept such a restriction on judicial alternatives:

> "We recognize that Wade and Gilbert are, therefore, the only victims of pretrial confrontations in the absence of their counsel to have the benefit of the rules established in their cases. That they must be given that benefit is, however, an unavoidable consequence of the necessity that constitutional adjudications not stand as mere dictum. Sound policies of decision-making, rooted in the command of Article III of the Constitution that we resolve issues solely in concrete cases or controversies [citing in a footnote the Yale Note, *supra*], and in the possible effect upon the incentive of counsel to advance contentions requiring a change in law, mitigate against denying Wade and Gilbert the benefit of today's decisions." *Stovall v. Denno,* 1967, 388 U.S. 293, 301, 87 S.Ct. 1967, 18 L.Ed.2d 1199, 1206.

On the other hand, the language in *Stovall* does not take the form of an absolute constitutional proscription. And Supreme Court authority for purely prospective overruling can be found in the following quote (and the authority cited therein):

permissible, must be a matter of judicial grace sparingly invoked. Especially in the administrative melange of taxation, appeasement by mandating moratoria should not be readily granted. *Massaglia v. Commissioner,* 10 Cir. 1961, 286 F.2d 258. The Tenth Circuit, in *United States v. Thomas, supra,* overruled its prior holding on carried interest taxation without even mentioning the possibility of relief through purely prospective application. We can find no greater cause for such relief in the case at bar than was present in the *Thomas* case, or in *Dixon v. United States, supra,* or *Massaglia v. Commissioner,* supra.[27]

"It has been suggested that this Court is prevented by Article III from adopting the technique of purely prospective overruling. Note, 71 Yale L. J. 907, 933 (1962). But see 1A Moore, Federal Practice 4082-4084 (2 ed. 1961) [currently, 1 B Moore, Federal Practice 190-198 (1965)]; Currier, *supra,* n.2 [Currier, "Time and Change in Judge-Made Law: Prospective Overruling," 51 *Va. L. Rev.* 201 (1965)], at 216-220. However, no doubt was expressed of our power under Article III in England v. Louisiana State Board of Medical Examiners, 375 U.S. 411, S.Ct. 461, 11 L.Ed.2d 440 (1964). See also Griffin v. Illinois, 351 U.S. 12, 20, 76 S.Ct. 585, 100 L.Ed. 891, 900 (1956) (concurring opinion of Frankfurter, J.)." *Linkletter v. Walker,* 1965, 381 U.S. 618, 622, 85 S.Ct. 1731, 14 L.Ed.2d 601, 604 (fn. 3).

[27]Nothing said in this opinion should be construed as fettering the Commissioner in alleviating the possible harsh effects of our decision by administrative means. We merely remind the Service of its past wanderlust, a symptom from which we too have not been immune. Pursuant to our request, the Department of Justice made a computer search for pending cases where the *Abercrombie* doctrine is in question. See Judge Brown's discussion of computer aid to the judicial process in *First National Bank of Birmingham v. United States,* 5 Cir. 1966, 358 F.2d 625, 631-32 (concurring opinion). They reported a total of ten additional cases being pursued involving carried interest transactions, five of which involve the Cockes (subsequent years).

VII.

The battle in this case is really over the right to the deduction accompanying the income during the recoupment period. The Internal Revenue Code provides premiums in the form of depreciation and depletion[28] to be awarded in connection with oil and gas operations. The same deductions cannot be taken by two parties. We here must determine which of the two is to be the beneficiary of the largesse. Our answer is the more intrepid of the two. Humble here made the essential contribution of risk capital for the enterprise. When the agreements were signed, Humble received from the Cockes the right to use the first oil produced to recoup that capital.

The argumentative justification for liberality in taxation of oil and gas is that such liberality encourages and emboldens the fiscally timid to exploit the hidden resource. It rewards the risktaker. Here Humble risked the exploration and development costs. If tax emoluments are to be granted, it would be cynicism in the name of economic bravery to give the tax break to the economic observer.

REVERSED.

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[28]The depletion deduction was arbitrarily set. *Kirby Petroleum Co. v. Commissioner, supra,* 326 U.S. at 603, 66 S.Ct. at _____, 90 L.Ed. at 347. Dean Galvin, *supra* note 20, at 1458-1463, explains the purpose underlying depletion as "reward for risk." He adds: "Percentage depletion deductions in excess of cost may be taken by owners of royalty, overriding royalty, production payment, and net-profit interests, who are not exposed to personal liability nor to cash commitments as are operators. This result, too, seems at variance with the underlying purpose of reward for risk." 73 *Harvard Law Review* at 1462.

APPENDIX

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * *

26 U.S.C. §611.

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not

exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * *

(c) *Definition of Gross Income from Property.*—For purposes of this section—

(1) *Gross income from the property.*—The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

* * *

26 U.S.C. §613.

SEC. 167. DEPRECIATION.

(a) *General Rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * *

26 U.S.C. §167.

SEC. 263. CAPITAL EXPENDITURES.

(a) *General Rule.*—No deduction shall be allowed for—

(1) any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—

(A) expenditures for the development of mines or deposits deductible under section 616,

(B) research and experimental expenditures deductible under section 174,

(C) soil and water conservation expenditures deductible under section 175,

(D) expenditures by farmers for fertilizer, etc., deductible under section 180, or

(E) expenditures by farmers for clearing land deductible under section 182.

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

* * *

Intangible Drilling and Development Costs in the Case of Oil and Gas Wells—Notwithstanding subsection (a), regulations shall be prescribed by the Secretary or his delegate under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development cost in the case of oil and gas wells and which were recog-

nized and approved by the Congress in House Concurrent Resolution 50, Seventy-Ninth Congress.

* * *

26 U.S.C. §263.

CLAYTON, Circuit Judge, specially concurring:

It is with reservations that I concur in my brother Goldberg's erudite funeral oration for *Abercrombie*. What we now do will limit carried and carrying parties in the exercise of unfettered rights to contract, within the law, and thus to fix, with propriety, the tax consequences of what they do, including rights to depletion. We may bring more certainty by prescribing more uniformity. Such a prescription is, perhaps, more properly legislative than judicial, since depletion originated and now exists as a matter of Congressional grace, and I am not now certain that we are doing what Congress had in mind or what the statutes require.

AINSWORTH, Circuit Judge, with whom Circuit Judges GEWIN, BELL and COLEMAN join (concurring in part and dissenting in part):

I am not entirely free of doubt that we should overrule *Abercrombie*. However, I am persuaded that the able and well-reasoned opinion of the Court by Judge Goldberg presents the better view in the long-standing controversy involving proper income taxation of carried interest oil and gas transactions. The majority opinion is based more realistically on the "economic interest" principle rather than on a rigid adherence to the concept of legal title.

Obviously we should not hesitate to overrule a decisional rule which we believe to have been incorrectly decided

originally. I concur, therefore, in the main portion of the majority opinion which overrules *Abercrombie*, though the principles we have promulgated today are not a panacea and it will still be necessary to consider other carried interest situations on a case-by-case basis because of the great variety of arrangements that can be adopted contractually. (See T.D. 6836, 1965-2 Cum. Bull. 182; T.I.R. 749).

Abercrombie has withstood the combined assaults of the Internal Revenue Service, numerous law commentators, and litigants for more than 20 years. During this time Congress has not seen fit to overrule *Abercrombie* legislatively. We do not know whether the demise of the *Abercrombie* rule will be long mourned by the petroleum industry. But it is certain that those taxpayers who, in reliance on the vitality of the principle there enunciated, have entered into continuing carried interest agreements will have no cause to rejoice. We must presume that the parties entered into their carried interest contracts with knowledge of the tax consequences provided by *Abercrombie* and its progeny. Now we have reversed the *Abercrombie* rule and radically changed the tax position of parties to such transactions. To prevent manifest injustice and hardship, therefore, to those who have contracted in reliance on this rule, I would make the overruling of the *Abercrombie* principle purely prospective in its application. In the present case, the Cockes entered into their carried interest arrangements in the years 1955 and 1956 —after *Abercrombie* was decided in 1947 and the Commissioner's non-acquiescence was withdrawn in 1949.

We are informed that there are ten pending cases in the Internal Revenue Service involving carried interest transactions, five of which affect the Cockes. The popu-

larity of the carried interest agreement in the petroleum industry permits the inference that it is likely there are a large number of such contracts in existence which will now be affected by our decision.

Prospective overruling is not an unkown legal principle. Cardozo first popularized it in *Great Northern Ry. Co. v. Sunburst Oil & Refining Co.*, 287 U.S. 358, 53 S.Ct. 145 (1932), though as early as 1848 the Ohio Supreme Court in declaring legislative divorces invalid confined the effect of its ruling to the future. See *Bingham v. Miller*, 17 Ohio, 445. A judicial decision overruling a former principle of law may properly be made purely prospective in its application, as is pointed out in the exhaustive treatise by Justice Schaefer of the Illinois Supreme Court entitled "The Control of 'Sunbursts': Techniques of Prospective Overruling," 22 Record of N.Y.C.B.A. June 1967, 1-29; see also Traynor, "The Well-Tempered Judicial Decision," 21 Ark. L. Rev. 287 (1967). Purely prospective application was referred to with approval by the Supreme Court in *Linkletter v. Walker*, 381 U.S. 618, 622, 85 S.Ct. 1731, 1733, f. 3 (1965), affirming the Fifth Circuit decision in *United States v. Walker*, 5 Cir., 1963, 323 F.2d 11. See also *England v. Louisiana State Bd. of Med. Exam.*, 375 U.S. 411, 84 S.Ct. 461 (1964). As the majority observes, the later case of *Stovall v. Denno*, 388 U.S. 293, 87 S.Ct. 1967 (1967), is not "an absolute constitutional proscription" to purely prospective overruling.

I, therefore, dissent from that part of the majority opinion which gives full retrospective effect to our decision and fails to provide only purely prospective application.

APPENDIX D

UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

October Term, 1967

No. 23,963

D. C. Docket Nos. 65-H-117 & 65-H-118
Civil Actions

UNITED STATES OF AMERICA,
Appellant,

versus

W. H. COCKE, ET AL.,
Appellees.

Appeal from the United States District Court for the Southern District of Texas.

Before BROWN, Chief Judge, TUTTLE, WISDOM, GEWIN, BELL, THORNBERRY, COLEMAN, GOLDBERG, AINSWORTH, GODBOLD, DYER, SIMPSON and CLAYTON, Circuit Judges.

JUDGMENT ON REHEARING

This cause came on to be heard on the transcript of

the record from the United States District Court for the Southern District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed, in accordance with the opinion of this Court.

July 31, 1968

CLAYTON, Circuit Judge, specially concurs.
AINSWORTH, Circuit Judge, with whom Circuit Judges GEWIN, BELL and COLEMAN join, concurring in part and dissenting in part.

Issued as Mandate:

APPENDIX E

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 23,963

UNITED STATES OF AMERICA,
Appellant,

v.

W. H. COCKE, ET AL.,
Appellees.

Appeals from the United States District Court for the Southern District of Texas.

ON PETITION FOR REHEARING

October 16, 1968

Before BROWN, Chief Judge, TUTTLE, WISDOM, GEWIN, BELL, THORNBERRY, COLEMAN, GOLDBERG, AINSWORTH, GODBOLD, DYER, SIMPSON and CLAYTON*, Circuit Judges.

PER CURIAM:

It is ORDERED that Appellees' Petition for Rehearing filed in the above entitled and numbered cause be, and the same is, hereby DENIED.

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* Due to illness Judge Clayton did not participate in the decision to deny appellees' petition for rehearing.

APPENDIX F

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * *

(26 U.S.C. 1964 ed., Sec. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the prop-

erty (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

Treasury Regulations on Income Tax (1954 Code):

§1.613.3. *Gross Income From The Property.*

(a) *Oil and gas wells.* In the case of oil and gas wells, "gross income from the property", as used in section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation.

(26 C.F.R., §1.613.3.)

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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 917

W. H. COCKE, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW, JURISDICTION, AND STATUTE INVOLVED

The opinions below, the basis for this Court's jurisdiction, and the statute involved are adequately set forth in the petition.

QUESTION PRESENTED

Whether petitioners, as the carried parties in an oil and gas venture whose allocable share of the drilling and development expenses was advanced by the

operator as carrying party, were entitled to include in their depletion base the production income which the carrying party retained as reimbursements for the advances and which was the only source of reimbursement available to the carrying party.

STATEMENT

William H. Cocke, Sr., William H. Cocke, Jr., and their wives ("petitioners"), were parties to two agreements for the drilling and development of oil and gas properties. The agreements involved petitioners' leasehold working interests and other mineral interests in St. Martin Parish, Louisiana (the "Goodrich K" properties), and Iberia Parish, Louisiana (the "Bayou Postillion" properties). (Pet. App. 46-47.)

The Goodrich K. contract was entered into on October 12, 1955. Under it R. H. Goodrich, and petitioner Cocke, Sr., entered into a joint operating agreement with Humble Oil and Refining Company to drill and develop the Goodrich K properties. Humble was designated the operator with control of exploration, drilling and development, and was given a 50 per cent interest in production. Petitioners Cocke, Sr., and Goodrich were designated non-operators and were each given a 25 per cent interest in production. Humble was obligated to advance all expenses and was entitled to reimburse itself for the non-operators' share of the expenses only out of one-half of the non-operators' 50 per cent share of the production income, if any. (Pet. App. 46-47.)

The Bayou Postillion contract, entered into on January 1, 1956, involved interests owned by Humble, the

California Company, petitioners and Goodrich. Humble was designated operator and was given a 40.302 per cent interest in production. The California Company was given a 48.06 per cent interest as a non-operator. Goodrich and petitioners, also as non-operators, were given an 11.638 per cent interest among them. Humble and California were required to advance all of the costs of drilling and development and could recoup the proportionate share of these outlays chargeable to petitioners and Goodrich only out of the income, if any, from one-fourth of their proportionate interest of 11.638 per cent. (Pet. App. 47-48.)

In their respective income tax returns for 1957 and 1958, petitioners reported as income the amounts which were recouped by Humble from production income to pay petitioners' share of the costs of drilling and development of the Goodrich K and Bayou Postillion properties. Petitioners also claimed the following deductions: (1) percentage depletion based on the proportionate share of drilling and development costs; (2) a similar proportionate share of intangible drilling and development costs incurred by Humble; and (3) a similar proportionate share of depreciation of the amounts paid by Humble for tangible assets used in developing the properties. (Pet. App. 49.)

The Commissioner of Internal Revenue determined that the portion of production income allocable to petitioners' proportionate shares which Humble retained to reimburse itself for production costs was not petitioners' income but was Humble's.[1] Accordingly, to

[1] Since the filing of the petition, petitioners' counsel has called to our attention the fact that the district court's find-

the extent they were based on such income, the deductions claimed by petitioners for depletion, intangible drilling and development costs, operating expenses, and depreciation were disallowed.[2] (Pet. App. 50.)

In petitioners' timely refund suit, the district court, relying on *Commissioner* v. *J. S. Abercrombie Co.*, 162 F. 2d 338 (C.A. 5), rendered judgment for petitioners. (Pet. App. 35-38, 51.) After a rehearing *en banc*, the court of appeals concluded (Pet. App. 83-84), that its "decision in *Abercrombie* must be overruled" (Pet. App. 40), and reversed.

ARGUMENT

The decision below is correct, and though there is a conflict it is not one which warrants further review.

1. The basic features of carried interest transactions may be illustrated by a simplified example in which an oil and gas venture is launched by two parties who share equally in the working interest. Under this type of arrangement, the parties agree that one of them (the "carrying" party) shall advance all of

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ings, as reprinted in the Appendix to the petition (at pp. 33-34), erroneously contain the word "not" in five places in the phrase "the amount not retained by Humble". This occurs on page 33 in the eighth and second lines from the bottom and on page 34 in the fourth, eighteen and twenty-sixth lines from the top. However, the district court's findings in this respect failed to describe accurately the government's position and the insertion of the word "not" is required to correct that description.

[2] The income reported and expenses claimed by petitioners but disallowed by the Commissioner also had been reported and claimed by Humble on its return. The Commissioner accepted that treatment. (Pet. App. 50, fn. 15.)

the costs of drilling and development with the right to recoup the share advanced for the other ("carried") party solely from a specified portion of the carried party's share of production. The carried party is not personally liable for costs and loses nothing if there is no production; on the other hand, if there is production, the carrying party has an absolute right to receive the specified portion of production income allocable to the carried party's interest until the former has recouped expenses advanced for the latter. Only after such recoupment (or payout, as it is usually called) does the carried party have the right to share equally in production income.[3]

The question is whether the portion of production income which is shifted pending payout from the carried to the carrying party is income for tax purposes

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[3] In the case at bar, these arrangements were made without disturbing the parties' proportionate interests in the oil and gas properties. There are two other types of carried interest arrangements. In the "Manahan" type (*Manahan Oil Co.* v. *Commissioner*, 8 T.C. 1159), the owner of the working (or leasehold) interest assigns the entire working interest, or fraction thereof, for a period of time measured by the period required for the recoupment of the development costs by the assignee. When such recoupment is accomplished, a portion, of the working interest reverts to the assignor. In the "Herndon" type of carried interest (*Herndon Drilling Co.* v. *Commissioner*, 6 T.C. 628), the owner of the working interest may assign an undivided fraction thereof, together with a production payment measured in terms of dollars of expenditures incurred by the assignee for the benefit of the assignor, which is payable out of the assignor's retained fractional interest. See Breeding and Burton, *Income Taxation of Oil and Gas Production* (1961 ed.), Sections 8.16 and 8.17; Hambrick, *Another Look At Some Old Problems—Percentage Depletion and the ABC Transaction*, 34 Geo. Wash. L. Rev. 1, 29 (1965).

to the former or to the latter. Whichever party must include the amount in income is also entitled to include it in his depletion base and to claim deductions for the proportionate share of intangible drilling and development costs, operating expenses, and depreciation.

In *Commissioner* v. *J. S. Abercrombie Co.*, 162 F. 2d 338, the Fifth Circuit held that this shifted portion of production income was the carried party's income. The court viewed income as necessarily following title, *i.e.*, as taxable to the parties (and hence includible in their depletion bases) in proportion to their legal interests in the property regardless of who, under their agreement, bore the expenses and had the risk of loss in the absence of production. The court regarded the carrying party's payment of the carried party's share of expenses as a "loan" which did not derogate from the carried party's right to deduct such expenses and claim depletion in the income.

In the case at bar, after rehearing *en banc*, the court overruled *Abercrombie*. Rejecting the *Abercrombie* ruling that title controls, the court held that the economic interest concept is the relevant touchstone and that petitioners, as carried parties (Pet. App. 61), "had no economic interest in the oil which produced the income questioned here." By way of corollary, the court further held that petitioners were not entitled to include the income in their depletion base, and were not entitled to deductions for expenses and depreciation since—as carried parties—they had not paid expenses or invested in equipment.

2. The decision here is sound. The economic interest concept, evolved by this Court in mineral cases,

governs the allocation between taxpayers of production income and depletion deductions attributable thereto, without regard to the portion of a mineral property to which a taxpayer may hold title under general principles of property law. A taxpayer holds a depletable economic interest to the extent that he has acquired by investment an interest in minerals in place and secures, by any form of legal relationship, income derived from extraction to which he must look for a return of his investment. *Palmer* v. *Bender*, 287 U.S. 551; Treasury Regulations on Income Tax (1954 Code), Section 1.611-1(b)(1) (26 C.F.R. 1.611-1). "The technical title to the oil in place is not important". *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 603. A taxpayer's depletable economic interest continues so long as he looks solely to the mineral, if, as and when produced, for a return of his capital. *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, 36; *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308, 312.

In carried interest transactions it is the carrying party who, until payout is completed, has the depletable economic interest in the specified portion of production to which he is entitled to look for recoupment of the costs he has advanced for the carried party's account. The carrying party has invested the costs advanced, and is dependent solely upon income derived from extraction—if, as and when there is production —for a return of his investment. Hence the portion of production income to which he is entitled, in recoupment of expenses advanced, is his taxable income and includible in his depletion base. By the same token,

he is entitled to the deductions for intangible drilling and development costs and depreciation; it is he and he alone who has been liable for, and has made, the expenditures which entitle a taxpayer to such deductions. Accord, *United States* v. *Thomas*, 329 F. 2d 119 (C.A. 9), certiorari denied, 379 U.S. 819.[4]

3. There is no conflict in decisions which now requires resolution by this Court (see Pet. 13 *et seq.*). While there are several early appellate cases which are not in accord with the instant decision, they have little if any remaining vitality in the light of intervening judicial history.

Reynolds v. *McMurray*, 60 F. 2d 843 (C.A. 10), certiorari denied, 287 U.S. 664, involved a transaction substantially similar to the one involved here. The Tenth Circuit's decision, rendered in 1932, was based (like *Abercrombie*) on the principle that income from property is to be taxed to the holder of legal title. However, that decision preceded this Court's initial formulation of the economic interest concept in *Palmer*

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[4] Petitioners' attempt (Pet. 21-22) to distinguish *Thomas* on the ground that it involved a net profits interest (a share of gross production measured by net profits) rather than a carried interest is without merit. While there are formal differences between the typical carried interest and net profits interest, both the carried party and the holder of the net profits interest have an economic interest only to the extent of the net amount they receive after the specified portion of production has been applied against the specified development expenditures made by the operator or carrying party. And both have no personal liability for payment of these expenditures. Therefore, as far as the issues of this case are concerned, the carried interest is, as the Ninth Circuit observed in *Thomas*, tantamount to a net profits interest.

v. *Bender*, *supra*. And because it was based on property law concepts rather than the economic interest concept, it was criticized and disapproved by the Ninth Circuit in *United States* v. *Thomas*, *supra*.[5] In the light of this Court's economic interest decisions and the later decisions of the Ninth and Fifth Circuits in *Thomas* and the instant case, it is doubtful whether the Tenth Circuit would subscribe to *McMurray* today.

T. K. Harris Co. v. *Commissioner*, 112 F. 2d 76 (C.A. 6), is another early appellate decision of questionable vitality. Moreover, it is distinguishable from the case at bar. In *Harris* the taxpayer, who owned real property, entered into an agreement with a gas company whereby the latter was to drill wells on the property at its own expense and to be reimbursed out of gas production. When the costs had been recovered, the wells were to become the property of the taxpayer, and the gas company was to continue operating the wells on specified terms and to buy the output. Thus, the gas company, unlike Humble in the present case, had neither a legal interest in the property nor an equity interest in the production enterprise. Although it was an independent contractor performing services for a fee and a purchaser of the mineral product, it never gained an economic interest in the minerals in place. Instead, the Sixth Circuit held that

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[5] The taxpayer's petition for a writ of certiorari in *Thomas*, alleged, as here, a conflict with *Reynolds* v. *McMurray* and *Commissioner* v. *J.S. Abercrombie Co.*, both *supra*. In its brief in opposition, the government responded that *McMurray* was an old case of questionable authority and that the scope of *Abercrombie* had been severely limited by the Fifth Circuit's decision in *Weinert's Estate* v. *Commissioner*, 294 F. 2d 750.

the gas proceeds applied toward reimbursement of drilling costs constituted income to the taxpayer, which was used by him to purchase the completed wells. Such a rationale would be impossible on the facts of the present case, and petitioners do not urge the Sixth Circuit's approach here.[6]

4. Petitioners urge (Pet. 26) that even if the court of appeals was correct in overruling *Abercrombie*, the rule should have been applied prospectively only and not in the instant case. There have been, to be sure, instances where this Court has applied new rules prospectively only. One example is *James* v. *United States*, 366 U.S. 213, where this Court held that embezzled funds constitute income to the embezzler, overruling *Commissioner* v. *Wilcox*, 327 U.S. 404. But that was a criminal action, and, as the Chief Justice observed (366 U.S. 221-222), the existence of *Wilcox* during the tax years involved made it impossible to conclude that the defendant had an intent to avoid taxes when he failed to report the pro-

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[6] There is no conflict with *Louisiana Land and Exploration Co.* v. *Donnelly*, 394 F. 2d 273 (C.A. 5) (see Pet. 25). The issue there was whether the lessor of oil and gas properties holding a net profits interest was entitled to include in its depletion base a portion of local severance taxes paid by the lessee but attributable to the lessor's interest. The decision is consistent with the present case because the Fifth Circuit, in holding for the lessor, grounded its decision principally on its view that the lessor, under local law, bore the risk of loss upon nonpayment by the lessee.

Nor is *Crane* v. *Commissioner*, 331 U.S. 1, pertinent here (see Pet. 15, 19). The problem there was computation of gain on the sale of an apartment house originally acquired subject to a mortgage, a problem having no relation to the considerations of economic interest that are peculiar to mineral transactions.

ceeds of the embezzlement as income. And in *England* v. *Medical Examiners*, 375 U.S. 411, on which petitioners rely (Pet. 12-13, 26), the Court made clear that an abstention order remitting litigants to a State court for decision of a State issue does not compel assertion of associated federal claims in the State courts, but that voluntary submission of federal claims to the State tribunal bars their reassertion in the federal district court. This rule was not applied to the litigants in *England*, but that was because they had reasonably interpreted prior decisions as requiring them to assert federal claims in the State court, and they would otherwise have been unable to have their substantive rights determined by a federal tribunal.

The more usual course, however, is that the federal courts apply a new rule at least to the litigants in the case where the rule is adopted, even though the ruling may, in other similar cases, be given prospective application only. Thus, in *Stovall* v. *Denno*, 388 U.S. 293, although the Court limited the effect of a new constitutional rule to prospective application, it recognized that the rule should nevertheless control in the litigation in which it had been established (see 388 U.S. at 301). See, also, *Johnson* v. *New Jersey*, 384 U.S. 719; *DeStefano* v. *Woods*, 392 U.S. 631; *Fuller* v. *Alaska*, 393 U.S. 80.[7]

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[7] *Linkletter* v. *Walker*, 381 U.S. 618, on which petitioners rely (Pet. 12, 26), is not helpful to them. There this Court limited the retroactive effect of a new constitutional rule announced in a prior case to cases on direct review at the time that case—*Mapp* v. *Ohio*, 367 U.S. 643—was decided. That ruling was thus applied not only to the litigant in that case, but also to other litigants similarly situated.

In the final analysis, the federal courts have, at the least, ample discretionary authority to apply a new rule retrospectively. As the court of appeals said here (Pet. App. 74-75), " 'Pure prospectively,' even if constitutionally permissible, must be a matter of judicial grace sparingly invoked. Especially in the administrative melange of taxation, appeasement by mandating moratoria should not be readily granted." In federal civil tax cases retroactive application of corrected interpretations of the law has indeed been the general rule, with such rules being given full application to the open years of all taxpayers affected. *E.g.*, *Estate of Geiger* v. *Commissioner*, 352 F. 2d 221 (C.A. 8), certiorari denied, 382 U.S. 1012; *United States* v. *Siano*, 356 F. 2d 927 (C.A. 2), and *Nerem* v. *Commissioner*, 41 T.C. 338, all of which held that *James* v. *United States*, *supra*, applies to funds that were embezzled prior to the *James* decision. See, also, *Helvering* v. *Hallock*, 309 U.S. 106, 119; *Commissioner* v. *Estate of Church*, 335 U.S. 632, 647-650.

Petitioners have shown no extraordinary circumstances which would warrant prospective overruling of *Abercrombie*. Their claim (Pet. 26) that they relied upon the Commissioner's acquiescence in *Abercrombie*[8] in entering these transactions in 1955 and

[8] Petitioners' recital (Pet. 16-20) of the changes in the Internal Revenue Service's administrative position with respect to this issue does not diminish the correctness of the decision below and of *Thomas*. Certainly, the fact that in 1949 (1949-1 Cum. Bull. 1) the Commissioner withdrew his original non-acquiescence (1946-2 Cum. Bull. 6) to *Abercrombie* provides no basis for questioning his present position or for providing petitioners with any basis for tax relief. (In 1963, the

1956 must be weighed, as the court below did (Pet. App. 71-74), against the knowledge, widespread at that time, that the Service disputed the *Abercrombie* rationale. See *Weinert's Estate* v. *Commissioner*, 294 F. 2d 750, 756-757.[9]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MARCH 1969.

Commissioner withdrew his acquiescence and reinstated his original nonacquiescence (1963-1 Cum. Bull. 5.)) It is well settled, of course, that the Commissioner may correct his own mistakes of law retroactively, pursuant to Section 7805(b) of the 1954 Code. *Dixon* v. *United States*, 381 U.S. 68; *Automobile Club* v. *Commissioner*, 353 U.S. 180.

[9] The instant case does not, as petitioners contend (Pet. 26), present an issue of unusual importance in the administration of the Internal Revenue laws. We are advised by the Internal Revenue Service that there are 10 cases pendi ; which involve carried interest transactions, five of which involve the claims of the instant petitioners for subsequent taxable years. These are the same 10 cases that were pending as of the time of the court of appeals' decision. (See Pet. App. 75, fn. 27.)

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SUPREME COURT, U. S.

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NO. 917

IN THE

Supreme Court of the United States

October Term, 1968

W. H. COCKE, ET AL., *Petitioners*

v.

UNITED STATES OF AMERICA, *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

REPLY BRIEF OF PETITIONERS

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NO. 917

IN THE

Supreme Court of the United States

October Term, 1968

W. H. COCKE, ET AL., *Petitioners*

v.

UNITED STATES OF AMERICA, *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

REPLY BRIEF OF PETITIONERS

We desire to file this reply brief to the brief in opposition by the respondent.

First, let us show briefly how wrong the decision below is. Petitioners owned an undivided interest in certain oil properties. Humble wanted to do the drilling and operating and was willing to pay petitioners' share of the development and operating expenses and look only to petitioners' share of the oil for reimbursement for petitioners' share of the expenses. Those representing the Government in

this case take the position exactly opposite to that of the Government in the Seventh Circuit in 1956 in *Commissioner of Internal Revenue v. Slagter,* 238 F.2d 901. Those presently representing the Government say that the oil and gas business is entirely different from all other businesses and cases involving it must be decided on the "modern concept of economic interest." Now, the fact that the oil and gas business is no different from any other business was pointed out by the Government itself in the *Slagter* case and the Seventh Circuit so held. A partnership, badly in debt, needed half a million dollars to continue its operation of producing oil. It borrowed this amount from another company and assigned to it sixty per cent of all the oil and gas saved by it. The Court sustained the Government's position that the amount paid to the lending company was nevertheless taxable income of the partnership, saying at 238 F.2d 904-905:

> "The production of oil and gas is an income-producing operation similar to a manufacturing business carried on on land. Anderson v. Helvering, 310 U.S. 404, at page 408, 60 S.Ct. 952, at page 954, 84 L.Ed. 1277, and cases there cited. The assignment here was similar in effect to a mortgage upon real estate or a manufacturing plant, conveying absolute title to the property to the mortgagee, but providing that upon payment of the amount stipulated it shall come to an end. If the mortgage be upon a factory, *even though there is no personal liability upon the part of the assignor,* if the assignor pledges the net proceeds of the operation of that factory, when those profits are realized and paid to the mortgagee, they are paid for the economic benefit of the mortgagor. They are his income, taxable as such.
>
> *"It is suggested by the taxpayers that there was no promise upon the part of the partnership to repay*

> *the funds.* We think that circumstance does not weaken the effect of the assignment as a promise to pay the income of the assignors to the assignee. It is not alone the personal promise of the assignor to repay that determines the relationship of the assignor to the income realized.
>
> "We conclude that the income in question was taxable as ordinary income of the taxpayers as it accumulated and was paid from time to time to Ashland, and that the tax liabilities should be computed for the years in question upon the amounts of income thus realized and paid to Ashland in the respective periods. . . ." (Emphasis added)

We ask: What is the difference between that case and our contentions in this case? The answer is "absolutely none."

Suppose that in this case petitioners had arranged with an insurance company to pay their bills when presented by Humble and had ordered all pipeline companies purchasing their oil to pay the proceeds to the insurance company. Could it conceivably be held that the income was that of the insurance company? Of course, it could not and for the same reason the court below was wrong in holding against petitioners.

We all know that in the present tremendous building activity insurance companies are loaning money to construct buildings and taking only a lien upon the building and underlying ground and an assignment of the rents to secure their loans without any personal liability on the part of the owner of the building. Yet none of these insurance companies are held to be taxable on the rents that are applied by them on the loans as their taxable income. There is no difference between that situation and that of the petitioners in this case.

We again say that the decision below is in direct conflict with the Sixth and Tenth Circuits in *T. K. Harris Co. v. Commissioner,* 112 F.2d 76 and *Reynolds v. McMurray,* 60 F.2d 843, and with the Tax Court in *Byron H. Farwell v. Commissioner,* 35 T.C. 454 (1960), and with this Court in *Crane v. Commissioner of Internal Revenue,* 331 U.S. 1, upon which latter case that of *Commissioner v. J. S. Abercrombie Co.,* 162 F.2d 338 was based. How can the present representatives say the *Harris* and *McMurray* cases are out of date because of the modern concept of "economic interest" when the courts in 1956 in the *Slagter* case (cited with approval in 1962 by the Fifth Circuit in *Sowell v. Commissioner,* 302 F.2d 177) and in 1960 in the *Farwell* case found no such modern development?

Another fallacy of the position of the Government and of the Court below is their attempt to justify the decision on the basis of the "risks" involved. For example, the Court below concluded its opinion as follows (Petition p. 76):

> "The argumentative justification for liberality in taxation of oil and gas is that such liberality encourages and emboldens the fiscally timid to exploit the hidden resource. *It rewards the risktaker. Here Humble risked the exploration and development costs.* If tax emoluments are to be granted, it would be cynicism in the name of economic bravery to give the tax break to the economic observer." (Emphasis added)

Likewise, the Government on page 7 of its brief in this case states:

> "In carried interest transactions it is the carrying party who, until payout is completed, has the de-

> pletable economic interest in the specified portion of production to which he is entitled to look for recoupment of the costs he has advanced for the carried party's account. *The carrying party has invested the costs advanced, and is dependent solely upon income derived from extraction—if, as and when there is production—for a return of his investment.* Hence the portion of production income to which he is entitled, in recoupment of expenses advanced, is his taxable income and includible in his depletion base." (Emphasis added)

Neither the Sixteenth Amendment nor the Internal Revenue Code speaks of "risk." The first simply empowers Congress to "collect taxes on income." Section 1 of the Code simply says "there is hereby imposed on the taxable income of every individual. . . ." If the question of risk is important, what about the financial risks taken by petitioners when they went out and bought leases and then arranged for Humble to operate them. They risked those outlays just as much as Humble did by spending money on drilling. "Risk" is no proper basis on which to decide this case.

We have been representing oil people since 1920 and know of no case that would have had as wide effect in the whole oil industry as this one if the decision below is allowed to stand. The Government in its brief (page 13, footnote 9) states that there are only 10 cases pending like this one and five of them are those of petitioners for later years. We have never known that the importance of a case depends on the number of active cases currently pending. Rather, we submit its importance is in the fact that throughout the oil industry there are many, many such contracts that so far are not in litigation. The importance of the case was pointed out by Judges Ains-

worth, Gewin, Bell and Coleman in their concurring and dissenting opinion (Petition, p. 81):

> "We are informed that there are ten pending cases in the Internal Revenue Service involving carried interest transactions, five of which affect the Cockes. The popularity of the carried interest agreement in the petroleum industry permits the inference that it is likely there are a large number of such contracts in existence which will now be affected by our decision."

We have pointed out in our Petition that the Government tried for years to write regulations covering this idea of treating the income retained by the so-called "carrying party" as its income and finally had to give it up entirely. This and the importance of this case have been dealt with by the Tax Section of the American Bar in The Tax Lawyer, Bulletin of the Section of Taxation, American Bar Association, Winter 1969, Vol. 22, No. 2, pp. 266-269, 273. We set out in Appendix A hereto that part of its report dealing with carried interest and we invite this Court's attention to that report but give at this point only the conclusion:

> "Conclusion
>
> "In view of the many questions in the field of G.C.M. 22730 presently pending before the courts, and those as to which recent decisions of the courts have created new uncertainties, general agreement on any restatement of the principles of the G.C.M. broadly acceptable at once to taxpayers and the Service seems unlikely. In the area of the G.C.M., it may be that, as in other fields of law, taxpayers will be forced to continue to seek their answers on an individual ad hoc basis through resort to the courts."

As stated above, we know of no other case that will have as wide ramification throughout the entire oil industry as this one and for that reason this Court should pass upon the questions involved.

The trouble with those in the Government who try to get away from the *Abercrombie* case is that they do not know anything about the oil business. They are constantly talking about there being no "personal liability," and about the shifting of the income during the "payout period." For example, we quote the following from the Government's brief on page 5:

> "The carried party is not personally liable for costs. . . ."
>
> "The question is whether the portion of production income which is shifted *pending payout* from the carried to the carrying party is income for tax purposes to the former or to the latter."

We have shown that the matter of personal liability is wholly immaterial. Likewise, in a case like the present, there is never any complete "payout." The operator Humble is obligated to pay not only the drilling expenses but all current operations from day to day and has the right to recover petitioners' portions from their part of the oil. Consequently, there never is a complete payout and when the Government people try to solve these questions on the theory of a payout period, they come to realize that they just cannot handle the question by regulations.

We have always felt that the expression "carried interest" is an unfortunate and completely misleading one. It infers that Humble was carrying petitioners free and

clear. However, Humble was at no risk and, when it is drilling a well today, it knows that it will recover the petitioners' costs through their present and future production.

We submit that the case is of such importance that our petition for writ of certiorari should be granted.

There is another question which we will not discuss in detail as it has been fully covered by our Petition. It is the error of the Court below in not making its decision overruling the *Abercrombie* case entirely prospective as to these petitioners. As pointed out in our Petition, four Judges of the Court below dissented and stated that it should be made purely prospective. The Government in their brief in this case state that petitioners should never have relied on the *Abercrombie* case of 1945 and subsequent cases following it because the Commissioner of Internal Revenue from time to time stated that he would not follow *Abercrombie* (Brief, 12-13). This is simply a statement that no one may rely on any decision at any time if the Commissioner says he does not like it. That is no basis upon which the refusal of the Court below to make its decision prospective as to petitioners can be sustained.

The Fifth Circuit decided the *Abercrombie* case in 1947 and followed the rule laid down there until in 1968 in this case an entirely new group of judges in that Circuit reversed the *Abercrombie* case. When these petitioners made their contracts involved in this case in 1955 and 1956 they relied upon this long-standing rule in the Fifth Circuit. They now have involved all of their operations under these contracts since 1956. The properties are still producing and petitioners will be involved in this

same question for years to come. We submit it is wholly unfair on the part of those representing the Government to say that, if this Court should sustain the overruling of *Abercrombie*, such action should not be made prospective as to these petitioners.

CONCLUSION

We respectfully submit that this case is of such importance that our petition for writ of certiorari should be granted and the case be set down at least upon the summary docket as it could be readily presented in the usual thirty minutes allowed in such cases.

Respectfully submitted,

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APPENDIX A

BULLETIN OF THE SECTION OF TAXATION AMERICAN BAR ASSOCIATION

REPORT ON PROPOSED REVISION OF GENERAL COUNSEL'S MEMORANDUM 22730

By Subcommittee of Committee on Natural Resources

(a) *Carried Interest*

Although the term "carried interest" in its broadest sense includes owners of all types of interests who are entitled to receive a share of the proceeds of production but do not bear a proportionate part of the cost of drilling, equipping or operating, the term as used herein will be limited to arrangements between the parties who are or who, pursuant to agreement, will become co-owners of the operating rights in oil and gas properties. Such an owner has made a contribution to the reservoir of capital investment of the several parties and is entitled to share in the proceeds of the minerals produced. He is "carried" to the extent that under the terms of the governing instruments and the applicable law he is not obligated to bear and pay that portion of the drilling, equipping and operating costs of the well or wells equal to his proportionate share of the gross production.

With the possible exception of the uncertainty of the limits of what constitutes an "economic interest," the "carried interest" area has provoked the most litigation and apparently the end is not in sight. This is one of the principal problem areas in any reconsideration of G.C.M. 22730.

G.C.M. 22730 states that the carried party has a non-depletable contractual right during the carrying period

and that the carrying party's advances are charged to a capital account.

Current view varies, depending generally on whether the transaction is a *Manahan, Herndon, Abercrombie* or *Burton-Sutton* type of arrangement, described below. In *Manahan Oil Co.*, 8 T.C. 1159 (1947), the carried party assigned its interest in the property to the carrying party until the payout was reached, and the Tax Court held that the carrying party was entitled to all the income and deductions during the payout period. If the carried party is entitled to share in the income and expenses thereafter, the carrying party must assign whatever basis he has remaining in the original investment in depreciable assets (and which is applicable to the interests of the previously carried party) to his depletable base. If the carried party receives an interest in the equipment when he comes back in, he will have to assign whatever basis he had in the original interest between the depletable and depreciable assets in accordance with their respective values. But, as to such conversion of depreciable costs into depletable costs, or vice versa, see *Choate v. Commissioner*, 324 U.S. 1 (1945).

In *Herndon Drilling Co.*, 6 T.C. 628 (1946), the carried party assigned a 75% interest in the working interest to the carrying party and in addition, assigned a production payment payable out of the 25% working interest retained. The production payment was of an amount equal to the expenditures to be made by the carrying party in drilling and developing the property, plus the profit factor. The carrying party then developed the lease 75% for his own benefit and 25% as consideration for the assigned production payment. The court held that the carrying party would be entitled to all the income

during the payout period but that he must account for such income as attributable to two separate property interests, 75% to the working interest and 25% to the production payment. The carrying party was allowed to deduct 75% of the intangible drilling and development costs and other expenses but was required to capitalize the remaining 25% of such items as well as 25% of cost of the tangible equipment as cost of the production payment acquired from the carried party.

In *Commissioner v. Abercrombie,* 162 F.2d 638 (5th Cir. 1947), the carried party assigned 75% of the working interest to the carrying party. The parties then entered into a contractual arrangement by which the carrying party was to advance the funds to develop the carried party's retained 25% interest. Although the carried party had no personal liability for repayment of these funds, the court held that he had a present interest in the production and improvements, subject, of course, to a lien held by the carrying party on both production and equipment as security for payment of the funds advanced. During the payout period the carried party was required to account for and was taxable on 25% of the income less 25% of the cost and expenses attributable to his interests. The carrying party was required to treat the advance as accounts receivable which if not paid by production or foreclosure of the lien on equipment would constitute a bad debt. The same rationale was followed by the Fifth Circuit in *Prater v. Commissioner,* 273 F.2d 124 (1959) and again by the District Court in *Cocke v. United States,* 263 F. Supp. 762 (D.C. Tex. 1966).

On appeal, the *Cocke* case was first submitted to a regular three judge panel of the Fifth Circuit but before any opinion was filed, reargument of the case before the court *en banc* was ordered. In its opinion (399 F.2d 433

(5th Cir. 1968), following the *en banc* hearing, the court reviewed the history of the litigation involving carried interests and held that the economic interest, as to the carried interest in the property, was in the carrying party sustaining risks in the development of the property recoverable only from production therefrom. The court thus overruled its earlier decision in *Abercrombie*. In so doing, though some arguable factual distinctions were present, it aligned itself with the decision of the Ninth Circuit in *United States v. Thomas*, 329 F.2d 119 (1964).

The decision in the *Cocke* case clarifies the situation where the carrying party may look only to production from the carried interest to recover his costs, but leaves the question unresolved where proceeds of the production might accrue directly to the carried party and where the carrying party might look to the general credit of the carried party but only to the extent of production proceeds actually received by that party. Cf. *Anderson v. Helvering*, 310 U.S. 404 (1940). Substantially the same economic risk is present in each case, because it is the deriving of substantial production from the property, or the failure thereof, which determines whether the carrying party will recover his advances.

In *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946), the carried party assigned his entire working interest in the lease and reserved a 25% net profits interest. The carrying party as owner of the operating interest was entitled to deduct all intangible drilling and development costs and expenses for the life of the property. Where the carried party will again receive income when the property reflects a net profit, he will at that time be entitled to the depletion allowance on the amount received. The carrying party will calculate his percentage depletion on his share of the gross income from the lease

excluding therefrom the landowner's royalty, any other overriding royalties and the carried party's net profits interest.

There are, of course, many other variations of the carried interest arrangment, all of which make it difficult if not impossible to find any consistent legal theory that can be applied to resolve the many problems between: (1) the assignor and (2) the assignee, with respect to the following questions: (a) who must report the income, (b) how much income should be reported, and, with respect to deductions, (c) who is entitled to the deduction for intangible drilling and development costs, (d) whether he is entitled to deduct all or only a fractional part, (e) if only a fractional part, then how is that fraction to be determined, (f) whether the balance is capitalized, and, if capitalized, is it to be recovered through depletion or depreciation, or part of both, (g) who is entitled to deductions for all operating expenses, (h) whether he is entitled to deduct all operating expenses or only a fractional part, (i) if only a fractional part, what happens to the balance of these expenditures, (j) who is entitled to the deduction for depreciation, (k) whether he is entitled to deduct all depreciation or only a fractional part, (l) if less than all, what happens to the balance of depreciation, (m) does the carried party realize income upon reversion of an interest in the lease and equipment to him, (n) can the carried party then take any depreciation allowance on his interest in this equipment, and (o) what happens to the carrying party's unrecovered basis in the equipment (and perhaps in the lease) at the time of the reversion to the carried party? In addition, a similar line of questions will arise with respect to investment credit.

* * * * *

CONCLUSION

In view of the many questions in the field of G.C.M. 22730 presently pending before the courts, and those as to which recent decisions of the courts have created new uncertainties, general agreement on any restatement of the principles of the G.C.M. broadly acceptable at once to taxpayers and the Service seems unlikely. In the area of the G.C.M., it may be that, as in other fields of law, taxpayers will be forced to continue to seek their answers on an individual ad hoc basis through resort to the courts.